88-38 (2)

No. _____

Supreme Court, U.S.
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In the

Supreme Court of the United States

October Term, 1988

NORTHWESTERN BELL TELEPHONE COMPANY,
Petitioner,

v.

MINNESOTA PUBLIC UTILITIES COMMISSION,
Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE MINNESOTA COURT OF APPEALS

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APPENDIX

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APPENDIX 1

OFFICE — JULY 17, 1984

The Commission met on July 17, 1984 with Chairman Adams and Commissioners Crump, Hanson, Hoffman and Kitlinski present.

The following items were passed unanimously by those commissioners present.

P 421 / GR-83-600
Northwestern Bell

Commissioner Hanson moved to reconsider the Commission's previous decision on the transfer of Yellow Pages to U. S. West Direct, capital structure and cost of debt.

The motion passed 5-0.

Commissioner Hoffman moved to disallow the transfer of yellow pages to U. S. West Direct, retain the new U. S. West consolidated capital structure, set the cost of debt of 8.15%, the debt component set at 43.85% resulting in an overall rate of return of 11.71%. The Company shall keep an actual accounting of the expenses and revenues associated with the production of yellow pages.

The motion passed 5-0.

There being no further business, the meeting was adjourned.

APPROVED BY THE COMMISSION
Leo G. Adams, Chairman
Harry Seymour Crump, Commissioner
Roger L. Hanson, Commissioner
Terry Hoffman, Commissioner
Cynthia A. Kitlinski, Commissioner

APPROVAL DATE:
7/24/84

ATTEST:
Randall D. Young
Executive Secretary

APPENDIX 2

BEFORE THE
MINNESOTA PUBLIC UTILITIES COMMISSION

Leo G. Adams	Chairman
Harry Seymour Crump	Commissioner
Roger L. Hanson	Commissioner
Terry Hoffman	Commissioner
Cynthia A. Kitlinski	Commissioner

Docket No. P-421/CR-83-600

In the Matter of the Application of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

Procedural History

On September 29, 1983, Northwestern Bell Telephone Company (Northwestern Bell, NWB or the Company) filed a petition for increased rates with the Minnesota Public Utilities Commission (the Commission), pursuant to Minn. Stat. § 237.075 (Supp. 1983). NWB's originally proposed change in rates would have increased its intrastate annual gross revenues by $109,461,000. In testimony filed February 8, 1984, the Company's proposed revenue increase was revised downward to $98,174,000. In its Initial Brief, filed on April 20, 1984, the Company's requested increase in annual revenue was stated to be $107,587,000.

The Commission accepted NWB's filing and suspended the proposed rates by Order dated October 21, 1983. On that same date, the Commission issued its Notice and Order for Hearing directing that a hearing be conducted on the Company's petition. Adminis-

trative Law Judge Bruce D. Campbell (ALJ) was assigned to the proceeding by the Office of Administrative Hearings.

Pursuant to Minn. Stat. § 237.075, subd. 3 (Supp. 1983), the Commission, by Order dated November 22, 1983, authorized and set the Company's interim rates at a level sufficient to collect $53,778,000 in additional annual revenue, subject to refund, pending a final Order by the Commission. The interim rates became effective for service rendered on and after November 28, 1983.

A prehearing conference was held by the ALJ on November 13, 1983. A Prehearing Order establishing the hearing schedule and procedural guidelines was issued on December 13, 1983. Pursuant to Minnesota Rules, part 1400.6200 Petitions for Intervention were filed and the following were made parties to the proceeding: the Minnesota Department of Public Service (DPS or the Department); the Residential Utilities Division of the Office of the Attorney General (RUD-AG); the Minnesota Department of Administration (DOA); Evan J. Henry, ratepayer; the Minnesota Public Interest Research Group (MPIRG); the Suburan Rate Authority (SRA); North Star Legal Foundation (NSLF): Recipient Families United for Justice (RFUJ); Minnesota Senior Federation (MSF); AT&T Communications of the Midwest, Inc. (AT&T/MW); the Minnesota Business Utility Users Council (MBUUC); the County of Ramsey; the United States Department of Defense on Behalf of the Interest of all Federal Executive Agencies (FEA); Polly Vesser, Renay Post, Sophie Jendro and Cindy Graham, ratepayers (St. Cloud Area Ratepayers or SCAR); the Coalition of FX Users (FX Users); Telecommunications Association of Minnesota (TAM); the Minnesota Radio Common Carriers Association (MRCCA); and NewVector were granted by Commission Orders of February 21, 1984 and March 21, 1984 respectively.

The ALJ conducted evidentiary hearing in St. Paul on January 9, 10–13, 16–20, 23–27 and 30, 1984; March 12–15, 19–23, 26 and 27, 1984; and April 5, 1984.

Appearances at the evidentiary hearings were as follows: James A. Gallagher and Gregory A. Ludvigsen, Attorneys, 200 South Fifth Street, Room 1800, Minneapolis, Minnesota 55402 and Richard A. Karre, Attorney, 1314 Douglas, Omaha, Nebraska 68102, represented Northwestern Bell Telephone Company; Kenneth

A. Nickolai, Susan W. Rester, James T. Jarvis, and Christopher K. Sandberg, Special Assistant Attorneys General, 1100 Bremer Tower, Seventh Place and Minnesota Street. St. Paul, Minnesota 55101, represented the Department of Public Service; Michael J. Bradley, Assistant Attorney General, and Thomas M. O'Hern, Jr., and Dennis D. Ahlers, Special Assistant Attorneys General, Residential Utilities Division, Office of the Attorney General, 340 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, represented the Attorney General, Hubert H. Humphrey: W. Richard Morris, Attorney, 10825 Old Mill Road, Omaha, Nebraska 68154 and Samuel L. Hanson, Attorney, Briggs and Morgan, 2400 IDS Center, Minneapolis, Minnesota 55402 represented AT&T Communications of the Midwest; Carla Kjellberg, and Gail Suchman, Attorneys, 2412 University Avenue Southeast, Minneapolis, Minnesota 55414, represented the Minnesota Public Interest Research Group; Kathleen M. Davis, Attorney, Minneapolis Legal Aid Society, 323 Fourth Avenue South, Minneapolis, Minnesota 55415, represented the Minnesota Senior Federation, Eliot Rothenberg, Attorney, 850 Builders Exchange Building, Minneapolis, Minnesota 55402, represented North Star Legal Foundation; Larry D. Starns, Special Assistant Attorney General, 204 Administration Building, 50 Sherburne Avenue, St. Paul, Minnesota 55155, represented the Minnesota Department of Administration; Lawrence R. McDonough, Attorney, St. Cloud Area Legal Services, 125½ East Broadway, Little Falls, Minnesota 56345, represented Polly Vesser, Renay Post, Sophie Jendro and Cindy Graham, ratepayers; Eldon J. Spencer, Jr., Attorney, 800 Northwestern Center, St. Paul, Minnesota 55101 represented the Coalition of FX Users; Glen E. Purdue and James M. Strommen, Attorneys, 2000 First Bank Place West, Minneapolis, Minnesota 55402, represented the Suburban Rate Authority; Carol Casebolt, Attorney, Legal Aid Society of Minneapolis, 222 Grain Exchange Building, Minneapolis, Minnesota 55415, represented Recipient Families United for Justice; William E. Flynn, Attorney, 3800 IDS Tower, 80 South Street, Minneapolis, Minnesota 55402, represented the Minnesota Business Utility Users Council; Elissa Mautner, Assistant Ramsey County Attorney, 200 Lowry Square, St. Paul, Minnesota 55102, represented the County of Ramsey; Russell L. Doty, Attorney, Suite

814, Degree of Honor Building, 325 Cedar Street, St. Paul, Minnesota 55101, represented the Minnesota Radio Common Carriers Association; Dwight M. Whitley, Attorney, 3350 161st Avenue Southeast, Bellevue, Washington 98008 and John B. Van de North, Attorney, Briggs and Morgan, 2400 IDS Center, Minneapolis, Minnesota 55402, represented NewVector Communications, Inc.; Evan J. Henry, Route 1, Box 60, Winona, Minnesota 55987, appeared *pro se;* and Karl W. Sonneman, Special Assistant Attorney General, and Mark E. Oberlander, Karin F. Leonard, and Everett J. Kulas, 780 American Center Building, 160 East Kellogg Boulevard, St. Paul, Minnesota 55101, represented the Minnesota Public Utilities Commission.

Public hearings to receive customer comments and questions regarding the proposed increase were held on the following dates and in the following locations. Parenthetical numbers indicate the number of persons attending each hearing. Bracketed numbers indicate the number of persons speaking at each hearing.

January 23, 1984	St. Paul	(150)	[12]	1:00 p.m.
January 23, 1984	St. Paul	(15)	[13]	7:00 p.m.
January 24, 1984	Winona	(35)	[18]	
January 25, 1984	Owatonna	(27)	[8]	
January 26, 1984	Marshall	(30)	[11]	
January 27, 1984	Willmar	(2)	[2]	
February 7, 1984	Duluth	(40)	[6]	
February 8, 1984	Virginia	(30)	[6]	
February 9, 1984	Crookston	(4)	[3]	
February 10, 1984	Moorhead	(3)	[1]	
February 21, 1984	Faribault	(140)	[12]	
February 22, 1984	Minneapolis	(500)	[12]	1:00 p.m.
February 22, 1984	Minneapolis	(30)	[12]	7:30 p.m.
February 23, 1984	Cambridge	(100)	[16]	
February 24, 1984	Little Falls	(85)	[14]	

Nineteen public exhibits were received into the record. Several additional public exhibits were offered but later excluded from evidence by the ALJ.

Due to the constraints, the ALJ declined to hold a public hearing in Duluth during the afternoon of February 7, 1984. An

"unofficial hearing" or public gathering was held without the presence of the ALJ. It is asserted that 134 people attended that gathering and an unofficial tape record of the proceeding and an attendance roster were introduced into the record at the evening public hearing as Public Exhibit 2. The ALJ estimatetd that more than 80% of the persons attending the public hearings were senior citizens. In addition to the testimony received at the public hearings, the ALJ received more than 300 letters, all of which were reviewed and included in the record of this proceeding. In the summary of public testimony that is contained in Part III of this Order, no distinction has been made between public oral testimony and public letters.

On April 26, 1984, Northwestern Bell presented to the Commission a proposed corporate restructuring. As part of its presentation, NWB provided documents which it had filed before the Federal Communications Commission (the FCC) which were designed to comply with an FCC order (CC Docket No. 83-115, released on December 30, 1983). The FCC, in that order, imposed the structural separation requirements of 47 C. F. R. § 64.704 on the divested Bell Operating Companies (BOCs) in their offering of customer premises equipment (CPE) and enhanced services if they intended to provide such services after the divestiture. NWB is one of the 22 divested BOCs.

In its presentation before the Commission, NWB informed the Commission that to comply with the FCC's December 30, 1983 Order it would incorporate a new holding company, Northwestern Bell Corporation on April 30, 1984. Northwestern Bell Corporation would have as its subsidiaries Northwestern Bell Telephone Company (NWBT), and Northwestern Bell Information Technologies, Incorporated. NWBT would encompass all present operations of NWB and would be regulated by the Commission. Northwestern Bell Information Technologies, Incorporated would be a new company formed on May 3, 1984, and would not be regulated by the Commission.

On May 4, 1984, the Commission issued an Order directing the DPS to investigate the corporate reorganization of NWB and affiliated corporations and to respond to specific Commission inquiries *In the Matter of an Investigation by the Minnesota Pub-*

lic Utilities Commission into the Corporate Restructuring of Northwestern Bell Telephone Company, Docket No. P-421/CI-84-192.

By letters dated May 8 and 9, 1984, the ALJ, on his own motion, convened a Post-hearing Conference and described to the parties the evidentiary status to be afforded the discussions occurring at the conference. The ALJ stated in a May 9, 1984 letter that his sole purpose in conducting the Post-hearing Conference was to attempt to reach some conclusions about the extent to which the record in this proceeding would reflect the business activities of the divested, reorganized company during the period within which any revised rate may be in effect. He emphasized that the purpose of the Post-hearing Conference was not to extend the hearing to accommodate additional substantive evidence regarding the reorganization of NWB. At the Post-hearing Conference, all counsel present were afforded an opportunity to make oral argument with respect to the matters discussed at the Conference.

Appearances at the Post-hearing Conference were as follows: Melvin R. Quinlan, Attorney, 1314 Douglas on the Mall, Omaha, Nebraska 68102 and James A. Gallagher, Attorney, 200 South Fifth Street, Room 1800, Minneapolis, Minnesota 55402, appeared on behalf of NWB; Kenneth A. Nickolai and Susan W. Rester, Special Assistant Attorneys General, 1100 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, appeared on behalf of the DPS; Thomas M. O'Hern, Jr., and Dennis Ahlers, Special Assistant Attorneys General and Michael J. Bradley, Assistant Attorney General, 340 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, appeared on behalf of the RUD-AG; James M. Strommen, Attorney, 2000 First Bank Place West, Minneapolis, Minnesota 55402, appeared on behalf of the SRA; Samuel L. Hanson, Attorney, 2400 IDS Center, Minneapolis, Minnesota 55402, appeared on behalf of AT&T/MW; Carla Kjellberg, Attorney, 2412 University Avenue S.E., Minneapolis, Minnesota 55414, appeared on behalf of MPIRG; Kathleen M. Davis, Attorney, Minneapolis Legal Aid Society, 323 South Fourth Avenue, Minneapolis, Minnesota 55415, appeared on behalf of the MSF; Larry D. Starns, Special Assistant Attorney General, 204 Administration Building, 50 Sherburne Avenue, St. Paul, Minnesota 55155, appeared on behalf of the DOA; William E. Flynn, Attor-

ney, 3800 IDS Tower, 80 South Eighth Street, Minneapolis, Minnesota 55402, appeared on behalf of MBUUC; Carol Casebolt, Attorney, Minneapolis Legal Aid Society, 222 Grain Exchange Building, Minneapolis, Minnesota 55415, appeared on behalf of RFUJ; Lawrence R. McDonough, Attorney, St. Cloud Area Legal Services, 125½ East Broadway, Little Falls, Minnesota 56345, appeared on behalf of the St. Cloud Area Ratepayers; John B. Van de North, Briggs and Morgan, Attorneys at Law, 2400 IDS Center, Minneapolis, Minnesota 55402, appeared on behalf of NewVector; and Mark E. Oberlander, 780 American Center Building, 160 East Kellogg Boulevard, St. Paul, Minnesota 55101, appeared on behalf of the Commission. In addition, each Commissioner of the Public Utilities Commission was present for all or a significant portion of the Post-hearing Conference.

Pursuant to written Motions, dated May 26, 1984, the following parties to the above-captioned proceedings timely requested that the ALJ recommend to the Minnesota Public Utilities Commission a summary disposition or dismissal of the pending general rate increase requested by Northwestern Bell Telephone Company; the DPS; the RFUJ; the St. Cloud Area Ratepayers; Evan J. Henry; the MPIRG; and the MSF. Such Motions were accompanied by supporting memoranda of law. On May 17, 1984, the DPS entered into a Stipulation with Northwestern Bell (Stipulation), and formally withdrew its previous Motion to Dismiss. On May 18, 1984, Northwestern Bell timely filed a memorandum of law opposing the Motions to Dismiss.

The ALJ submitted the Recommendation of Administrative Law Judge Regarding Motions for Summary Disposition or Dismissal to the Commission on May 22, 1984.[1] The ALJ recommended that the application of NWB for authority to charge its schedule of telephone rates for Minnesota customers be dismissed for failure of the Company to sustain its statutory burden of proof. Minn. Stat. § 237.075, subd. 4 (Supp. 1983).

On May 23, 1984, the Commission met to consider the ALJ's Recommendation of Dismissal. The Commission viewed the Recommendation as a possible final disposition of a contested case

[1] The Commission has exempted portions of that Recommendation herein without specific attribution.

proceeding. Minn. Stat. § 14.61 (1982) provides that in a contested case a final decision cannot be made until the report of the ALJ has been made available to parties for at least 10 days and affords an opportunity for adversely affected parties to file exceptions and present oral argument. Consequently, Oral Argument on the ALJ's Recommendation for Dismissal was held on June 5, 1984. The following parties participated in the Oral Argument: MPIRG, MSF, RFUJ, St. Cloud Legal Services, NWB, DPS, MBUUC, and RUD-AG.

On June 8, 1984, the Commission sent a letter to the ALF stating its belief that due process would best be served by addressing the restructuring issue within the context of this proceeding. The letter stated that the Commission intended, upon rendering a decision on the record of this proceeding to move on its own motion for rehearing on all the additional issues occasioned by the restructuring. The Commission requested that the ALJ issue his Report on the basis of the existing record.

Post hearing briefs were received by the ALJ on May 30, 1984 at which time the record closed.

The ALJ submitted Part I of his Report to the Commission on June 19, 1984. He submitted Part II on June 26, 1984.[2]

The Commission heard Oral Argument on July 9, 1984.

Notice is hereby given that pursuant to Minnesota Rules, part 7830.4100 petition for rehearing or other post-hearing relief, by any party adversely affected, must be filed within 20 days of the mailing data hereof (original plus 11 copies) with Randall D. Young, Executive Secretary, Minnesota Public Utilities Commission, 780 American Center Building, 160 East Kellogg Boulevard, St. Paul, Minnesota 55101, with proof of service on all parties. The grounds relied upon shall be specifically set forth and the claimed errors clearly stated in the petition. If desired, adverse parties may file and serve answers (original plus 11 copies) within 10 days after service of the petition. The Commission may, in its discretion, grant oral argument on the petition or may decide the petition without oral argument.

Now upon review of the entire record herein, the Commission makes the following Findings, Conclusions and Order:

[2]The Commission has exempted portions of that Record herein without specific attribution.

FINDINGS AND CONCLUSIONS

I. JURISDICTION

The subject matter of this proceeding is properly within the jurisdiction of the Commission by virtue of Minn. Stat. Ch. 237, and was properly before the ALJ by virtue of Minn. Stat. §§ 14.48–14.56 (1982) and Minnesota Rules, part 1400.5100 *et seq.* The hearings held herein were convened pursuant to proper notice. The Commission has fulfilled all relevant substantive and procedural requirements of law and has the authority to now act.

II. NORTHWESTERN BELL TELEPHONE COMPANY

Prior to January 1, 1984, Northwestern Bell Telephone Company was an Iowa Corporate, wholly owned by its parent corporation, American Telephone and Telegraph Company (AT&T), which provided telephone service in Minnesota, North Dakota, South Dakota, Nebraska and Iowa. The 22 Bell operating companies, Western Electric Company, Bell Telephone Laboratories and the Long Lines Department were all integrated units of the Bell Telephone System.

When Northwestern Bell's rate application was originally submitted, the Plan of Reorganization filed by AT&T to effectuate divestiture as a consequence of *United States v. American Telephone & Telegraph Co.*, 522 F.Supp. 131 (D.C. 1983), *aff'd*, 103 S. Ct. 1240 (1983), had been approved by the Federal District Court; however, divestiture had not yet taken place.

On January 1, 1984, AT&T divested itself of the Bell Operating Companies (BOCs). Ownership of these companies was transferred to seven new Regional Holding Companies (RHCs). The RHCs are autonomous from each other and from AT&T.

Northwestern Bell Telephone Company, Mountain States Telephone and Telegraph Company and Pacific Northwest Bell Telephone Company are subsidiaries of U.S. West. Inc. (US West), one of the seven Regional Holding Companies resulting from the Plan of Reorganizaton. US West provides service in fourteen states in the Pacific Northwest, Southwest, Rocky Mountains, and Great Plains regions of the country. US West operates several nonregulated subsidiaries. The estimated combined assets of the subsi-

diaries comprising US West were $17 billion on June 30, 1983, with projected operating revenues for 1984 of $7.4 billion.

Northwestern Bell is currently a wholly-owned subsidiary, through an intermediate holding company, of US West and provides telephone service in the same territory both in Minnesota and surrounding states as it did prior to divestiture of the Bell Operating System.

III. SUMMARY OF PUBLIC TESTIMONY

Divestiture

The most often repeated comment by members of the public both in oral and written testimony was a sense of bewilderment and dissatisfaction with the deregulation ordered by the Federal District Court. Many public witnesses testified that they would receive no benefit from deregulation. Proceedings concerning access charges, confusion between service provided by AT&T and NWB and the large requested rate increase by NWB served, in the public perception, only to confirm that opinion. The general sentiment was in favor of a return to the "plain old telephone service" experienced by the average residential ratepayer prior to divestiture.

Many people expressed dissatisfaction over the public information offered by NWB and AT&T with respect to their individual functions. Specific concern was voiced about the lack of adequate 800 number lines by AT&T, AT&T's apparent plans to service certain telephones by mail and the confusion resulting from NWB including in its billings charges for inter-LATA long distance calls for AT&T. A frequently repeated question, especially by the elderly, was whether they should purchase their phone or continue to rent the equipment. An additional problem experienced by many customers is the inability to read and understand Company billings. It was suggested that the form of the bill is confusing and, because of the extremely small print, difficult to read.

There appears to be a public perception that the breakup of AT&T will benefit business and long distance users to the detriment of the individual residential ratepayer. Some public witnesses even suggested that it was the desire of the Company to largely aban-

don concepts of universal service and concentrate on long distance, business service and sophisticated data transmission.

It was suggested that NWB and AT&T coordinate their efforts to explain the services being provided by each and to address matters of public concern caused by divestiture.

***

IV. TEST YEAR

In January of 1982, AT&T and the Department of Justice (DOJ) entered into an agreement to settle an antitrust action commenced by the DOJ against AT&T in 1974. In that settlement agreement, AT&T agreed to a massive restructuring of the Bell System. After protracted proceedings, the United States District Court of the District of Columbia (Divestiture Court) formally approved the settlement in the form of a Modification of Final Judgment (MFJ) on August 24, 1983. One of the major requirements of the MFJ was that AT&T submit a detailed Plan of Reorganization (Plan or POR) which was approved as modified on August 5, 1983, by the Divestiture Court.

On January 1, 1984, the Bell Operating Companies (BOCs), including NWB, were divested from AT&T pursuant to the terms of the MFJ and the POR. As a result of divestiture, the License Contract Agreement with AT&T, the Business Information Systems (BIS) Agreement with Bell Labs, and the Standard Supply Contract with Western Electric were terminated. Under the Plan, assets used solely for exchange telecommunications, exchange access functions, and directory functions were assigned to the BOCs. Conversely, the ownership of customer premises equipment (CPE) and assets used solely for interexchange functions was assigned to AT&T. Assets used to provide both exchange and interexchange functions were assigned on the basis of predominant use. With regard to personnel transfers between NWB and AT&T, the fundamental principle of the Plan was that employees followed their work.

As a result of divestiture and the MFJ, NWB has been restricted in the scope of its activities and services. NWB may no longer provide interexchange telecommunications services. NWB may only

provide exchange service or service within Local Access and Transport Areas (LATAs), provide exchange access for the purpose of originating or terminating interexchange telecommunications (inter-LATA), and provide directory services.

The Company's test year in this proceeding was based on 1983 actual data adjusted as though the Company had operated on a divested basis throughout 1983. The Company utilized a divestiture overlay approach to restate 1983 actual data. NWB projected 1984 investment, revenue, and expense data on both a pre-divestiture and post-divestiture basis and determined a relationship between post-divestiture and pre-divestiture data-divestiture ratios. Those divestiture ratios were applied to actual combined 1983 data to determine post-divestiture operations. Estimated 1984 separation factors were then applied to obtain the intrastate post-divestiture test year data. In developing the divestiture ratios, the Company utilized the Disvestiture Guidelines jointly prepared by AT&T and the BOCs pursuant to the MFJ and in compliance with the POE as the basis for determining the split of revenues, investment, and expenses between NWB and the AT&T entities.

The Company has offered to provide to the Commission a specific intrastate accounting of actual 1984 results, indicating the rate of intrastate return actually realized in the first full post-divestiture year, calculated according to the Commission's own findings. The Company has offered to make appropriate refunds to customers to reduce the earned return for 1984 to the authorized level, in the event that the Company earns in excess of the authorized rate of return during 1984 for intrastate operations.

The RUD-AG advocated that the 1983 test year be presented on a pre-divestiture basis claiming that the divestiture effects incorporated into the revenue requirements of the Company are not known and determinable. The RUD-AG charged that the Company had not adequately supported the reliability of its divestiture overlay procedure and that the Company's refund offer should not be accepted as a substitute for proof.

The DPS recognized that an unadjusted actual 1983 test year cannot be considered representative of NWB's future operations in a post-divestiture environment. Consequently, DPS witness Louiselle presented the test year on a post-divestiture basis. His first approach

was to use a modified divestiture overlay approach similar to that used by NWB. He also presented an alternative approach which was based on the assumption that the revenues NWB lost upon divestiture were producing earnings at the same rate as all other intrastate revenues. His second alternative approach assumed that the divested revenues were earning at the same rate as all of NWB's interstate services.

The ALJ found it appropriate to reflect the effects of divestiture on NWB stating that to ignore divestiture would be to ignore reality. The ALJ also found that the general divestiture overlay approach was the most reasonable method of accounting for the effects of divestiture and for determining prospective rates for NWB. The ALJ also suggested that the Commission require the Company to provide periodic reports during the time revised rates are in effect and that the Company should be required to refund to ratepayers amounts earned in excess of its authorized rate of return. He noted that the Company had volunteered to do so with respect to 1984.

The ALJ found that 1983 revenues and rate base could be measured as if divested directly without the use of the estimation factors contained in divestiture ratios. He found that calculations relying on a direct divestiture of assets and revenues demonstrated that the divestiture ratios developed by the Company with respect to such items tended to understate the Company's revenue requirement. He also found that 1983 expenses could not be divested directly and that it was appropriate to treat investment, revenues, and expenses with a consistenet divestiture overlay technique.

Although the ALJ believed that the process by which the Company developed its divestiture ratios involved a large measure of unverifiable subjectivity, he stated that the Company's direct divestiture of 1983 revenues and investment established the fundamental integrity of the overlay process, at least in regard to revenues and rate base. The ALJ stated that the alternative approach suggested by the Department was not the primary recommendation of its expert witness. The ALJ considered the use of a divestiture ratio overlay approach superior to the alternatives presented by both the DPS and the RUD-AG.

Although the Company generally agreed with the ALJ's findings, it took exception to Findings 52 and 53, which indicated a lack of

evidence and documentation as to how Divestiture Guidelines were applied. The Company pointed out that with regard to investments, the updated divestiture ratios were a direct result of the actual asset transfers to AT&T effective January 1, 1984. The Company stated that the itemization of the asset transfers and company witness Quinn's workpapers that developed the investment overlay percentages based on those transfers are in the record. In rebuttal testimony, Mr. Quinn presented testimony and workpapers showing that a direct divestiture of 1983 revenues indicated that the use of the overlay process for purposes of estimating revenues was conservative in nature. With regard to expenses, witness Yerger testified that the split of expenses was done by each of the operating organizations that were in the best position to apply the Divestiture Guidelines and determine their operational impacts. The split of expenses was accomplished by assessing the job functions that employees were performing and then determining which entity, NWB or AT&T, will perform that job function after divestiture. Job function codes, location codes, and work/time reports were used to help determine the splits.

The Department excepted to the ALJ's adoption of the Company's divestiture overlay approach as "the most reasonable method of accounting for the effects of divestiture." the DPS stated that there was no way to determine the accuracy of the Company's portrayal of post-divestiture expenses until after December 31, 1984. Thus, the DPS contended that it is impossible to state whether the Company's divestiture overlay approach understates or overstates its revenue requiremnet. The DPS argued that its alternative approaches are no more subjective or verifiable than the Company's overlay approach but are equally defensible.

The RUD-AG decided not to except to ALJ's rejection of its position. The RUD-AG stated that the ALJ's acceptance of divestiture ratios in a disaggregated form as adjusted by the DPS and his acceptance of various adjustments proposed by the DPS and RUD-AG resulted in a reasonable approach to this unique and complex issue.

The Commission is in general agreement with the findings, rationale and recommendations of the ALJ that the effects of dives-

titure should be recognized in this proceeding and that a divestiture ratio overlay approach should be utilized to measure the divestiture effects. The Commission agrees that the Company's direct divestiture of 1983 revenues and investment, as indicated in its rebuttal testimony, in rebuttal substantiated the reliability of the overlay process as it relates to revenues and rate base.

The Commission also agrees that the Department's alternative approach was not the primary method sponsored by its expert witness. Very few pages of Mr. Louiselle's supplemental and surrebuttal testimony relate to his two alternative approaches. The revenue loss in his alternative approach was based on a comparison of 1983 intrastate revenue on a pre-divestiture and post-divestiture basis. The post-divestiture revenue used in that comparison was the final revenue number calculated by Mr. Louiselle in his divestiture overlay approach after *pro forma* adjustments. Thus, the divestiture overlay process was utilized to determine the revenue loss in the DPS alternative approach. The Commission believes that the rate base after divestiture can more accurately be determined by use of an overlay approach that is based on the actual asset transfer that occured than by arbitrarily calculating the divested rate base as a function fo revenue loss.

The Commission concludes, as did the ALJ, that the use of the divestiture ratio overlay approach to account for the effects of divestiture is superior to the alternatives presented by both the DPS and the RUD-AG. The Commission will determine whether to use aggregated or disaggregated divestiture ratios as it considers rate base, revenues, and expenses.

The ALJ recommended that the Commission require the Company to report on a period basis its activities during the period of time within which the revised rates remain in effect as a check against the accuracy of the divestiture ratios used in this proceeding. He further recommended that the Commission should require the Company to refund or credit to ratepayers amounts earned in excess of its authorized rate of return. This recommendation was prompted, in part, by NWB's voluntarily offering to make such refunds or credits with respect to 1984.

While the Commission would encourage the Company's voluntary efforts to refund rates that are shown to be excessive when

the haze of divestiture is removed and the actual results are known, the Commission has given little weight to such a refunding proposal since there is no way to enfoce such a proposal. Final rates determined as a result of this case are just that — final rates. As the Commission has recently noted in *Continental Telephone Company*, Docket No. P-407/GR-83-294 (May 14, 1984), p. 2:

> Rate making proceedings have reasonably finite time limits. Indefinite and unknown contingencies should not cloud the Commission's determination of this issue [interest imputed to JDIC portion of rate base] in this case. The Commission also finds that the RUD has not shown that Minn. Stat. § 237.075 (1983) provides the Commission authority to make final approved rates subject to refund as proposed by the RUD.

Once final rates are established, the Commission recognizes that it could lower those rates only prospectively after affording the Company the opportunity for hearing. While the Commission encourages the Company to follow through with its undertaking to refund, its decision on this issue has been made upon the record before it and is not based upon the refunding offer.

V. RATE BASE

In its rebuttal testimony, the Company proposed an average intrastate rate base of $1,005,113,000 on a post-divestiture basis. In its surrebuttal presentation, the DPS recommended a divestiture adjusted intrastate rate base of $1,009,751,000 based on its divestiture overlay approach.

The following Company rate base adjustments were adopted by the DPS without modification: loans under the Special Terminal Equipment Funding Program, removal of paging investment, adjustment for CPE phase-out, and an adjustment to deferred income taxes related to AT&T refunds. The Commission also accepts those adjustments without further discussion.

The individual items comprising the rate base and the proposed adjustments to the rate base, which are in dispute, are discussed in detail in the subsequent paragraphs.

A. Divestiture Ratios

The Company and the DPS applied identical divestiture ratios to the following rate base items: depreciation reserve, plant held for future use, short term telephone plant under construction, accumulated deferred income taxes, pre-1971 investment tax credits, and material and supplies. However for the major rate base item, plant in service, the DPS applied 27 discrete divestiture ratios to the individual component accounts included in plant in service. The Company, on the other hand, applied on composite, aggregated divestiture ratio to average 1983 plant in service to obtain the post-divestiture plant in service.

The DPS stated that Mr. Quinn developed 1984 divestiture ratios for the various plant accounts. Rather than aggregating the impact of all those discrete components and applying the aggregated ratio to 1983 combined average plant in ervce, the DPS applied each discrete ratio to the appropriate, related 1983 plant account. The DPS witness Louiselle stated that in each case where the Company developed discrete divestiture ratios and provided 1983 values for those discrete items, he used those values.

The ALJ found that it was appropriate to use the 27 different plant divestiture ratios reflected in the DPS testimony and exhibits. The ALJ stated that the Company's use of an aggregated ratio for plant in service overstated the effect of divestiture on rate base.

The Company urged the Commission to follow a consistent approach with regard to the use of test year data and with regard to developing divestiture ratios. The Company claimed that the use of disaggregated ratios in some instances, and aggregated ratios in others, can lead to severe distortions that are avoided if the consistent approach utilitized by the Company is followed. The Company stated that while viewed in isolation the use of aggregated ratios for plant accounts may tend to overstate the rate base, the record is clear that the use of a consistent approach for both rate base and revenues would tend to significantly understate the Company's revenue requirement.

The Commission accepts the ALJ's recommendation to use disaggregated divestiture ratios for the various classes of plant included in plant in service. The Commisison believes that the use of disag-

gregated divestiture ratios constitutes a superior method that produces more accurate and reliable results. The Commission finds that the post-divestiture average 1983 plant in service on a combined basis is $2,142,515,000 as calculated in DPS Exhibit 348, Appendix page 2.

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VII. RATE OF RETURN

A. Introduction

NWB sponsored four witnesses to address rate of return issues. Dr. Robert Litzenberger, Professor of Finance at Stanford University, testified to the return on common equity. Mr. Robert B. Morris III, a senior security analyst with Montgomery Securities, also testified to the return on common equity. Mr. William L. Bauhard, Assistant Treasurer of Northwestern Bell Telephone Company, addressed the return on common equity, cost of debt, and capital structure. Mr. Eugene W. Meyer, Vice President and Director of Kidder, Peabody and Company, Inc., tested the adequacy of the Company's requested rate of return on equity and its proposed capital structure.

The DPS sponsored the testimony of Dr. Eilon Amit, Rate Analyst, who addressed the rate or return on common equity, and Dr. Luther C. Thompson, Rate Analyst, who addressed the capital structure and the cost of debt. Dr. Matityahu Marcus, Professor of Economics at Rutgers University, testified to the return on common equity and the capital structure on behalf of the RUD-AG. Dr. Brett A. Smith, Staff Economist or the MPIRG, addressed the rate of return on common equity on behalf of the MPIRG.

The Company proposed the use of a 13.0% overall return on its Minnesota intrastate rate base in calculating its proposed revenue deficiency. The DPS recommended an overall return of 11.76 %. The RUD-AG recommended an 11.60% overall return. The MPIRG limited its testimony to return on common equity and did not recommend an overall rate of return for NWB. The ALJ found an 11.76% overall rate of return to be appropriate.

The Commission will discuss the testimony of each witness and the Report of the ALJ with regard to the rate of return on common equity, capital structure, and cost of debt. The Commission will then make its findings and conclusions and determine the overall rate of return to be authorized for NWB.

B. Testimony of the Witnesses and Report of the ALJ.

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2. Capital Structure and Cost of Debt.

Mr. Bauhard

Mr. Bauhard initially recommended that the Commission adopt NWB's projected post-divestiture capital structure as of 1/1/84. He felt that NWB's capital structure had become the most appropriate means to determine the overall fair rate of return in this proceeding because he no longer relied on AT&T's cost of equity to estimate NWB's cost of equity. This recommendation was a change from the recommendation he made in NWB's previous rate case, *NWB*, Docket No. P-421/GR-82-203, where he recommended that the Commission use the Bell System consolidated capital structure. He felt that the focus on NWB rather than AT&T recognized the effects of divestiture.

Mr. Bauhard began the determination of his recommended capital structure for NWB by first taking the capital structure for NWB at 12/31/83 which consisted of $1.259 billion long term debt, approximately $53 million short term debt and approximately $2.273 billion common equity for a total of $3.585 billion capital. This resulted in a capital structure for NWB at 12/31/83 of approximately 36.6% debt and 63.4% equity.

To determine a projected actual capital structure for NWB as of January 1, 1984, Mr. Bauhard estimated that NWB, at divestiture, would transfer approximately $441 million of its equity to AT&T. The Company would also require additional short term debt financing of approximately $27 million on January 1, 1984. This combined with the $53 million in short term debt as of 12/31/84 would result in about $80 million in short term debt financing for NWB as of 1/1/84. If Mr. Bauhard's estimates were correct, NWB would

have $1.832 billion equity and $1.339 billion debt as of January 1, 1984. The resulting debt to equity ratio would be 42.2% debt to 57.8% equity. Mr. Bauhard argued that this capital structure would barely meet the standards for the Triple-A debt rating NWB enjoyed prior to the divestiture.

In his written rebuttal testimony, Mr. Bauhard updated his recommendation for NWB's capital structure to reflect the fact that NWB transferred approximately $23 million in equity to US West for directory advertising on January 3, 1984. This transfer was financed with $23 million in short term debt. As his final recommendation, Mr. Bauhard urged the Commission to adopt NWB's actual capital structure as of January 3, 1984 which contained 43.6% debt and 56.4% equity.

During his oral rebuttal testimony, Mr. Bauhard mentioned that NWB planned to issue $150 million in long term debt in March 1984. The Company did not recommend any changes in its proposed actual capital structure to reflect the issuance of this debt.

With regard to the cost of debt, Mr. Bauhard initially argued that NWB's average embedded cost of debt was 7.8%. This recommendation was subsequently modified to reflect the January 3, 1984 $23 million short term debt financing. This revision brought the cost of debt up to 7.93%. The Company subsequently changed its 7.93% recommendation to 8.5% to reflect its issuance of $150 million in long term debt securities in March 1984 at a cost of 13.69%.

Mr. Meyer

Mr. Meyer described the financial policies and results necessary for NWB and its parent, US West, to maintain access to the long term credit markets and the equity markets on reasonable terms.

Mr. Meyer examined the coverage ratio and capital structure requirements on long term bond investments as indicated by bond rating agencies. He measured the advantages and disadvantages of various bond ratings to NWB both in terms of cost to the ratepayer and financial flexibility to the Company. In addition, he discussed the importance of stock price to the financibility of US West and its operating companies and, in turn, the importance of earning a rate of return on equity and utilizing a dividend policy which would enable US West to achieve net proceeds of not less than

book value when issuing new common stock.

Mr. Meyer presented the minimum financial requirements of companies necessary to maintain credit ratings at various levels as stated by Standard & Poor's and as followed by Duff and Phelps, and Moody's.

Mr. Meyer felt that it was essential for NWB to maintain a capital structure consistent with triple A and double A ratings to raise additional increments of debt capital in the future.

Mr. Meyer also felt that it was critical that US West adopt a dividend policy necessary to provide a market-to-book ratio of at least 120% and hopefully more. To do this Mr. Meyer felt that it was necessary to have a dividend-to-book ratio of 10.25% to 10.50% and a payout ratio of 66 2/3%. He felt that this dividend policy combined with investor expectations of a growth rate in earning per share of 6.9% to 8.6% per annum should produce a minimum market-to-book ratio of 120%.

In the future, if US West engaged successfully in non-regulated business, Mr. Meyer felt that there should be the opportunity to enhance the market-to-book ratio of the Company, thereby lowering the cost of capital. If the Company was able to issue its new common stock at net proceeds above book value, then the growth rate necessary to attract investors was enhanced and the rate of return on equity necessary to achieve competitive total return declined.

Dr. Thompson

Dr. Thompson recommended that a hypothetical capital structure be used for NWB as of 1/1/84 which consisted of 42.2% debt, 7.8% imputed debt, and 50.0% common equity.

Dr. Thompson argued that the reasonableness of a capital structure for regulatory purposes must be based upon objective benchmarks. He felt that a useful benchmark was an average capital structure for a group of comparable companies.

Dr. Thompson felt that the determination of the actual capital structure of a company was the prerogative of management. However, for regulatory purposes, he argued that it was the Commission which must decide what capital structure is fair and reasonable to use in determining the overall allowed rate of return to be

earned on the utility's rate base. Dr. Thompson felt that the determination of a operational capital structure from an accounting perspective for a utility as a subsidiary of a diversified company was primarily a decision for company management, but where it was appropriate and necessary, the Commission could impose or impute a capital structure different from a compnay-proposed capital structure when it was reasonable to conclude that the proposed capital structure was inappropriate for regulatory purposes.

Dr. Thompson argued that the determination of that capital structure should be made using references to industry comparisons based upon risk relationships and industry averages to determine appropriate benchmarks. Although the Company management had the responsibility of establishing an operational capital structure for a subsidiary, the reasonableness and safety of that imuted capital structure for regulatory purposes rested with the Commission.

Dr. Thompson based his imputed or hypothetical capital structure upon a review of several comparable groups. He considered this a reasonable balance between investors' and consumers' interests. He started with NWB's projected capital structure on 1/1/84 and compared its projected common equity ratio (57.8%) with common equity ratios of comparable groups.

One of his comparable groups consisted of the companies used by Dr. Amit in his cost of common equity analyses. A second and third group were selected based on the testimony of Mr. Bauhard and Mr. Morris, and two additional groups were those used by Dr. Litzenberger. Dr. Thompson also looked at the capital structure used in the last NWB rate case which contained 50.1% common equity.

Dr. Thompson determined his recommended 50% equity ratio by looking at the most recent common equity ratios for the comparable groups. The common equity ratios for these companies ranged from a high of 61.69% (Cincinnati Bell) to a low of 33.54% (Mid-Continent). For a AA regulated company he felt that a 50% equity ratio was appropriate for ratemaking purposes.

Dr. Thompson treated the difference between his proposed 50% equity ratio and the company proposed 57.8% equity ratio as a separate type of capital and assigned to it a current average cost of AA rated debt. AA was the current rating of NWB and was similar to ratings for comparable groups of companies.

Based on his analysis and regulatory considerations, he believed that his recommended capital structure was a reasonable estimate for NWB Minnesota's capital structure for regulatory purposes during the current regulatory period.

Mr. Meyer argued that if the Commission adopted Dr. Thompson's hypothetical capital structure and then it was subsequently adopted by the Company, the Company's bond rating would be, in all probability, downgraded. As a result, the cost of capital would increase and the availability of new capital would decrease.

With regard to the cost of debt, Dr. Thompson felt that 7.8% was a reasonable estimate for the average embedded costs of long term debt for NWB during the current regulatory period. He felt it was consistent with the use of his proposed capital structure. In addition, he believed that the current cost of debt of 12.8% (average from November 1982 to October 1983) contained in Moody's November 1983 bond record for a AA rated utility was a reasonable estimate for regulatory purposes for the excess portion of the common equity he proposed be treated as a separate form of debt (imputed debt).

Dr. Thompson recommended an overall rate of return for NWB of 11.51% using the 7.8% return on long term debt, 12.8% return on imputed debt and 14.46% on common equity.

In its Proposed Findings of Fact and Conclusions of Law, the DPS revised Dr. Thompson's recommendations to reflect updated numbers. The DPS's final recommendation with regard to an appropriate capital structure for NWB and an overall rate of return consisted of 43.6% debt (at an 8.5% cost, increased from the previous 7.93% to reflect the issuance of $150 million in long term debt), 6.4% imputed debt (at a 12.83% cost) and 50% equity (at a 14.46% cost) for an overall cost of capital of 11.76%.

Dr. Marcus

Dr. Marcus testified that the appropriate capital structure should match the entity on which the cost of equity is being based. In this proceeding, he recommended the use of US West on which to base the cost of quity and therefore argued that US West's consolidated capital structure should be used to determine NWB's overall rate of return. US West's consolidated capital structure as of 1/3/84 con-

tained 44.06% debt and 55.94% equity. According to the Company, this capital structure reflected only the consolidated operations of US West's regulated entities, which included NWB, Pacific Northwest Bell, and Mountain States.

Prior to market data being available on US West, Dr. Marcus initially recommended a capital structure containing 45% debt and 55% equity. He employed several guidelines to determine his appropriate capital structure for NWB. These were (1) the capital structures employed by other utilities, (2) the capital structure trends for the Bell System, and (3) the capital structure standards set forth in the Consent Decree.

To observe the capital structure employed by other utilities, Dr. Marcus considered all Aa-rated electric utilities. These utilities averaged a 39.8% common equity ratio. He also considered the common equity ratios of non-Bell telephone utilities. Their average equity ratio was 52.5%. He also reported the financial statistics for another group of telephone companies with significant non-telephone sources of revenues and noted that the average common equity ratio for the group was only 41.7% but that their bond rating was generally weaker (Baa). Finally, he noted that the trend in AT&T's capital structure was of interest.

It was apparent to Dr. Marcus that the Bell System's common equity ratio had been quite stable at about 50% from 1978 through 1980, but had since displayed a sharp increase. Dr. Marcus stated that AT&T's 1982 common equity ratio of 55.6% already represented a rise of 500 basis points in just two years. He said this increase had been justified by AT&T citing the rise in competitive risks.

His initial conclusion that the Commission base its authorized overall rate of return on a capital structure containing 55% common equity and 45% debt was based on the following considerations:

1. NWB's proposed capital structure with 57.8% equity and 42.2% debt was a projection. The actual ratio upon divestuture might differ depending on the actual amount of assets transferred to AT&T.

2. A 55% equity level was significantly higher than the common equity ratio of high grade electric utilities (Aa bond rating).

3. A 55% equity ratio was consistent or higher than the capital structure of non-Bell telephone companies.

4. The 55%–45% mix already reflected the enormous rise in the Bell System's common equity accomplished between 1980 and 1982.

5. The 55%–45% mix was the standard set in the Consent Decree.

6. US West was a new business entity for which no direct risk measures were yet available. A decision to authorize a higher Ratio than 55% should be made only based on explicit evidence.

In its Proposed Findings of Fact and Conclusions of Law, the RUD-AG presented its final recommendation as to the appropriate capital structure for NWB and the resulting overall rate of return. The RUD-AG argued that the evidence in this case supported an overall rate of return of 11.60% based on a capital structure containing 44.06% debt and 55.94% common equity, with the cost of debt being 7.93% and the rate of return on equity capital being 14.5%.

This final recommendation was a result of Dr. Marcus' further testimony that US West's consolidated capital structure should be used as the appropriate capital structure for NWB.

With regard to the cost of debt, Dr. Marcus agreed with Mr. Bauhard's initial updated recommendation of 7.93% as the actual embedded cost of debt for NWB. The RUD-AG did not subsequently accept, however, NWB's revised cost of debt of 8.5%, arguing that it was not adequately supported by record evidence. The RUD-AG, in its Initial Brief recognized that the embedded cost of debt for US West was 8.69%. However, the RUD-AG advised the Commision that if it wished to use, as closely as possible, the costs associated with serving ratepayers, NWB's embedded cost of debt of 7.93% should be used.

The Administrative Law Judge

The ALJ found that NWB did not sustain the burden of proof that the actual capital structure of the Company was appropriate for regulatory purposes. Based on this finding, he determined it was appropriate to attribute to NWB a hypothetical capital structure based on objective tests of propriety.

To determine his hypotheticial capital structure, the ALJ took into consideration several different observations on regulated com-

panies' equity ratios. He determined an average equity ratio of 45.65% for five groups of companies selected by the parties as comparable to NWB and found that figure provided an objective benchmark in judging the capital structure to be assigned to NWB for regulatory purposes. He also determined that the weighted average authorized common equity ratio for regulatory purposes of US West's regulated telephone operations was 51.58%. He found as a consequence of his considerations that it was appropariate to retain the common equity ratio authorized in the NWB's last general rate case, such that the appropriate hypothetical capital structure contained 50.1% common equity and 43.6% debt. He also found it was appropriate to impute to the Company, for inclusion in its capital structure, 6.3% additional debt.

The ALJ recommended that the embedded cost of debt was 8.5%. This reflected the addition of a $150 million debenture issue at a cost of 13.69% during the week of March 18, 1984.

He assigned the latest 12 month average cost of debt, 12.83%, to the 6.3% imputed debt he included in the Company's capital structure.

The ALJ recommended that the Commission authorize an overall rate of return for NWB of 11.76% based on a capital structure that included 50.1% equity (at a 14.46% cost), 43.6% debt (at a 8.5% cost), and 6.3% imputed debt (at a 12.83% cost).

The Company objected to the ALJ's finding that the use of a 50.1% equity ratio in this proceeding would be consistent with the Commission's action in the last NWB rate case. NWB argued that the result was identical to the last case, but the means to achieve that result were not. In NWB's last rate case, the Company proposed and the Commission adopted the Bell System consolidated capital structure excluding Western Electric's equity, that is, the structure of NWB's ex-parent AT&T minus Western Electric equity. NWB argued that if the ALJ had wished to adhere to the precedent of NWB's last rate case, he should have utilized the consolidated capital structure of the three telephone operating companies of NWB's new parent, US West, as the RUD-AG had recommended.

The Company, however, did not recommend the use of the consolidated capital structure, but maintained that its actual capital structure should be used. At a minimum, NWB argued, the Com-

mission should hold that the capital structures of the Bell regional holding companies and the requirements of the MFJ are sufficient evidence to sustain the use of the Company's actual capital structure.

C. Commission Findings and Conclusions.

Introduction

In this proceeding, the Commission was presented with a difficult task regarding the determination of a fair and reasonable rate of return on equity for NWB, the selection of an appropriate capital structure and the determination of the cost of NWB's debt in a post-divestiture environment. The difficulty of the task was exacerbated by the lack of reliable evidence in the post-divestiture period in terms of the evidence's substance and historical perspective upon which the Commission could base its decisions. The transfers of equity to AT&T, a consequence of divestiture, the transfer of equity to US West, a post-divestiture transaction to reflect the transfer of the Yellow Pages advertising operation and telephone directory operations (which the Commission voided, earlier in this Order), and the issuance of debt to finance such transfers further confused and complicated the record because no concrete data was presented by the Company regarding such transfers.

In the past, the Commission has determined the capital structure and rate of return for AT&T and applied the results to NWB, which prior to divestiture was a wholly-owned subsidiary of AT&T. The Company argued in this proceeding that it was no longer appropriate to use AT&T as a proxy for NWB. Instead, the Company recommended that the Commission utilize NWB's actual capital structure for the purposes of determining an overall rate of return. The Company argued that the focus should be shifted away from AT&T and on to NWB to recognize the affects of divestiture. To determined NWB's cost of equity, however, the Company advocated the use of US West as a proxy for NWB.

The Commission agrees with the Company that it is no longer appropriate to use AT&T as a proxy for determining NWB's cost of equity nor should AT&T's capital structure be utilized to determine NWB's overall rate or return. The Commission also agrees with NWB that the determination of a fair and reasonable rate of

return for NWB should utilize US West as a proxy for NWB. Given the lack of historical data on US West that existed during the record of this proceeding, however, the Commission will also utilize data from the six other Bell regional holding companies in its determination of a fair rate of return on equity for NWB.

The Commission will depart from the Company's recommendation regarding the appropriate basis for NWB's capital structure, however, and will focus on US West in order to determine NWB's appropriate capital structure. The Commission believes that shifting the focus to NWB's new parent, US West, more appropriately recognizes the effects of divestiture and the new umbrella organization under which NWB finds itself in the reorganized post-divestiture environment than does focusing exclusively on NWB.

The DPS argued that the lack of reliable market and historical data about NWB's post-divestiture parent US West made it impossible to use US West as a proxy for determining NWB's cost of equity. The DPS also did not advocate the use of US West in the selection of an appropriate captial structure for NWB.

The Commission agrees with the DPS that informative data on US West is lacking historically. However, the Commission finds that the data available on the record regarding US West and the six other Bell regional holding companies as presented in the aggregate by the RUD-AG's witness Dr. Marcus is reasonably reliable evidence upon which to base a decision gives the circumstances of this case where information regarding the post-divestiture environment is lacking from the start. In addition, the Commission finds that the desire to be consistent with past determinations (the use of AT&T as a proxy), when, as in this proceeding, the record justifies consistency with past practices (although AT&T has been replaced by US West) convinces the Commission that the use of US West and the other Bell regional holding companies as a proxy group for determining NWB's rate of return on equity and the utilization of US West's consolidated capital structure to determine NWB's overall rate of return is reasonable and appropriate.

With respect to the appropriate cost of debt, however, the Commission finds that the record of this proceeding demonstrates that debt financing was not coordinated on an integrated, system-wide basis as it was under the AT&T parentage and therefore, the Commission will depart from its past practice of assigning the par-

ent company's consolidated cost of debt when its consolidated capital structure is used.

The Commission will discuss below in more detail its findings and conclusions with respect to NWB's cost of equity, the appropriate capital structure to utilize in determining the overall rate of return to NWB and the cost of debt:

Return on Common Equity

As an administrative agency, the Commision must act both within the scope of its enabling legislation and the strictures of reviewing judicial bodies. Two United States Supreme Court cases provide these general guidelines for Commission rate of return decisions:

1. The allowed rate of return should be comparable to that generally being made on investments and other business undertakings which are attended by corresponding risks and uncertainties.

2. The return should be sufficient to enable the utility to maintain its financial integrity.

3. The return should be sufficient to attract new capital on reasonable terms.

Bluefield Water Works & Improvement Co. v. P.S.C., 262 U.S. 679 (1923), *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

No particular method or approach for determining a rate of return was mandated by those cases, but the necessity of a fair and reasonable rate of return was clearly stated:

> Rates which are not sufficient to yield a reasonable return on the value of the property used, at the time it is being used to render the service, are unjust, unreasonable, and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment. *Bluefield Water Works*, 262 U.S. at 690.

The Minnesota Supreme Court's latest decision on rate of return was stated in *Minnesota Power & Light Company v. Minnesota Public Service Commission*, 302 N.W.2d 5 (Minn. 1980). The Court stated:

> . . . The Single term "ratemaking" has been used to describe what is really two separate functions — (1) the establishment of a rate of return, which is a quasi-judicial function, and (2) the allocation of rates among classes of utility customers, which is a quasi-legislative function.
>
> . . . we now hold that the establishment of a rate of return involves a factual determination which the court will review under the substantial evidence standard.

302 N.W.2d at 9.

In conducting its evaluation of the Commission's decision, the Court explained:

> . . . A reviewing court cannot intelligently pass judgment on the PSC's determination unless it knows the factual basis underlying the PSC's determination. Judicial deference to the agency's expertise is not a substitute for an analysis which enables the court to understand the PSC's ruling. Henceforth, we deem it necessary that the PSC set forth factual support for its conclusion. The PSC must state the facts it relies on with a reasonable degree of specificity to provide an adequate basis for judicial review. We do not require great detail but too little will not suffice.

302 N.W.2d at 12.

In order to provide the factual bais for its decision required by the Court, the Commission has reviewed the testimony of each of the parties on rate of return on common equity, the objections raised thereto by other parties and the recommendation of the ALJ. Based on that review, the Commission makes the following findings with regard to a fair rate of return for NWB's common equity:

The Commissin finds that the DCF method is the appropriate method for estimating NWB's cost of equity. This method is a market-oriented, opportunity cost approach which views the relationship between the cost of equity, investor's income expectations and market price in a theoretically sound and systematic manner. Using the DCF method, an analyst may infer the rate of return investors implicitly require of a particular equity investment. Under

the DCF theory, the return expected by investors is the sum of the expected dividend yield of the stock and the expected growth in dividends.

All witnesses testifying to the rate of return on common equity utilized the DCF method as their primary method. Two company witnesses, Mr. Morris and Dr. Litzenberger, also relied on variations of the risk premium method as secondary methods of analysis. The two main difficulties with the application of a risk premium approach are the need to find firms of comparable risk to the utility in question and the need for a quantifiable and reasonably stable risk premium.

Mr. Morris utilized a conventional risk premium analysis. This method attempts to measure the additional return required by investors in common stock compared to investors in government bonds. The Commission finds that Mr. Morris did not overcome the difficulties associated with the use of the risk premium analysis. Mr. Morris developed his risk premium by taking the average 7.70% risk premium of stock over a firm's cost of long term debt suggested by research done by Ibbotson and Sinquefield. He characterized 7.70% as the market risk premium and multiplied it by his composite group's beta, .61, arguing that the composite's risk premium over debt should be 61% of the market premium as a whole at a minimum. The composite's risk premium then became 4.70% (.61 x 7.70%). If this was Mr. Morris' attempt to justify the comparable riskiness of his risk premium to NWB, his attempt has failed because he did not demonstrate that the average market risk premium was reasonably stable. The Commissin is convinced after reviewing Dr. Amit's exhibit showing various expected risk premiums that the determination of a risk premium value varies depending upon which riskless asset is used to compare with stock returns. Dr. Amit's exhibit also demonstrated that the value of the risk premium is not stable over the years and can vary by as much as 8 percentage points (the risk premiums observed between the years 1951 and 1981 based on U.S. Bonds, A-rated industrial, AAA-rated industrials and AAA composite).

Dr. Litzenberger used a form of the capital asset pricing model (CAPM), which he characterized as a variant of the risk premium approach. The CAPM equates the expected return on a given stock to the return on a riskless asset such as Treasury bills, plus the

premium required on the market as a whole adjusted for the risk of the stock in question. The security-specific risk measure is beta, which measures the extent to which the return on the stock moves with the market as a whole. The CAPM exhibits some of the same shortcomings as the traditional risk premium approach in that the market risk premium is quite volatile and the yield on Treasury Bills or bonds is also subject to rapid change. For example, Dr. Litzenberger's original cost of equity estimate using the CAPM was 17.7% (a combination of the 12.1% yield to maturity on government debt reported on August 8, 1983 and an estimated risk premium of 5.6%). His updated cost of equity estimate four months later was 17.1% utilizing the same CAPM method and the 5.6% risk premium. The yield on the riskless asset, twenty year government debt, had dropped to 11.8% (as reported on Janary 17, 1984). The Commission finds the results of the CAPM and risk premium analyses in this record to be unreliable as guides for determining the appropriate return on equity for NWB.

The Commission finds the DCF method of estimating NWB's cost of equity capital to be reasonable and appropriate in this proceeding. Of the several DCF analyses presented in this proceeding, the Commission finds that the analysis performed on the seven Bell regional holding companies (US West included) as a group by the RUD-AG's witness, Dr. Marcus, is the most appropriate and reliable guide for determining the cost of equity for NWB because it acknowledges the realities of the post-divestiture environment NWB now finds itself in.

In the pre-divestiture past, the Commission based NWB's cost of equity on AT&T's cost of equity. Reliance on AT&T's data was appropriate, because AT&T supplied all of NWB's external equity requirements, and AT&T was risk comparable considering the many operating and financial similarities of the Bell operating companies that comprised AT&T. The divestiture, which severed AT&T from its Bell Operating companies, renders this reliance on AT&T data inappropriate for post-divestiture equity analyses. NWB, as a result of divestiture, became a wholly-owned subsidiary of US West, a Bell regional holding company. US West now provides NWB with all of its external equity requirements.

The Commission finds Dr. Marcus' approach particularly appealing because it recognizes the inadequacies of the financial and

operational data available on US West which prevented the use of estimating the cost of equity of US West directly based only in its own market data and financial characteristics. Dr. Marcus circumvented the problem by aggregating the available data on the seven Bell regional holding companies and analyzing them as a group.

The Commission agrees with the ALJ that the data available for the Bell regional holding companies is limited and lacks historical perspective. When evaluated as separate entities, the Bell regional holding company data is subject to a degree of subjectivity. However, Dr. Marcus used the most representative and reliable data that does exist with respect to the Bell regional holding companies and rather than looking at the companies individually, he analyzed them as a group. The Commission agrees with Dr. Marcus' position regarding the greater reliability for the DCF results for the regional companies as a group than the results for US West alone: the regional companies are new corporate entities functioning in a new environment. Projections for an individual Bell regional holding company will therefore be subject to greater error than projections for established companies with performance records. Averaging the growth projections for the individual regionals will reduce errors contained in individual projections.

Dr. Litzenberger, in his supplemental testimony, presented a DCF analysis on US West. The Commission rejects his analysis because it was based primarily on US West alone and the analysis itself was flawed. The Commission has acknowledged that the data on the Bell regional holding companies individually is limited. Because of the lack of historical perspective particular abberations associated with US West are likely to be heightened. Dr. Marcus' use of the regionals as a group reduced the possible errors and abberations contained in individual projections.

The major flaw in Dr. Litzenberger's DCF testimony, however, was his reliance on security analysts' forecasts to determine an expected growth rate. The Commission has consistently rejected the use of analysts' forecasts as an appropriate method for determining the growth rate (*NWB* Docket No. P-421/GR-82-203). Investment reports frequently offer differing dividend and earnings growth rates, and employ different periods of observation. The methodology underlying their estimates and the use which the analysts make of their estimates are also not uniform. Finally, Dr. Litzenberger did

not provide any evidence that the analysts he cited are representative of the universe of analyst reports.

Mr. Morris' DCF analysis leaves the Commission as bewildered as the ALJ as to how Mr. Morris determined his growth estimate. His recommendation was based heavily upon projections from various sources for growth in the general economy and in the firms which made up his composite group without accompanying evidence in the record regarding the source of such projections or the viability of the assumptions contained in them. This reason alone is sufficient for the Commission to reject Mr. Morris' DCF analysis.

The DCF analysis of Mr. Bauhard is rejected because of his use of analysts' forecasts for his DCF growth component. Mr. Bauhard relied on three investment services. As was mentioned in the discussion of Dr. Litzenberger's DCF testimony, the Commission has previously rejected the use of such forecasts.

The Commission rejects Dr. Smith's DCF analysis for two reasons. First, he did not base his recommendation on an analysis of US West and the Bell regional holding companies. Second, his analysis itself suffers from several deficiencies which in the absence of the Commission's desire to use US West and the Bell regional holding companies as a proxy group, would have rendered Dr. Smith's testimony unreliable upon which to base a recommendation. Specifically, the Commission cannot rely on Dr. Smith's individual growth rate estimates for the companies in his comparable group because Dr. Smith acknowledged in his oral testimony that the individual estimates could not be considered appropriate for each of the respective companies. The Commission agrees with the ALJ that the selection of companies in Dr. Smith's comparable group has considerable influence over the outcome of his analysis because of the large disparities in Dr. Smith's individual growth estimates.

Absent his rejection of the use of US West and Bell regional holding company data, the Commission finds Dr. Amit's DCF analysis to be representative of a consistent application of the DCF method. The Commission will utilize Dr. Amit's analysis as a secondary check on the analysis of Dr. Marcus. Dr. Amit estimated 14.46% as a reasonable return on equity for NWB.

Since the ALJ selected Dr. Amit's testimony to determine his recommended cost of equity, the Commission's findings with respect

to Dr. Amit's testimony apply as well to the ALJ's recommendation. The Commission is confident of its decision in this case, since the ALJ found that Dr. Marcus used the most representative and reliable data that did exist with respect to the Bell regional holding companies.

Dr. Marcus estimated the seven Bell regional holding companies to have an expected growth rate of 5.1%. Although this estimate was based on projections for 1984, the Commission finds that in this proceeding its desire to utilize Bell regional holding company data (even though that necessitates the use of numbers with limited historical perspective) outweighs the use of historical data on groups of telephone companies with comparable risk. Dr. Marcus estimated an average dividend yield of 9.40% utilizing stock prices of a week in duration and 1984 dividend payment projections. Given the lack of historical stock price information on US West, the Commission finds this figure to be appropriate. In subsequent NWB rate cases when more historical data is available on US West the Commission will not hesitate, if record evidence demonstrates it to be appropriate, to use the historical evidence in its determination of expected growth rates and expected dividend yields.

Combining Dr. Marcus' 9.40% dividend yield with his 5.1% expected growth rate results in a rate of return on NWB's common equity of 14.5%. The Commission finds this to be a fair rate of return on NWB's common equity. The Commission will not make any adjustments to this final determination for issuance costs, since US West, in its financial forecast statement of November 8, 1983 stated that it expected to meet all its capital requirements in 1984 through internally generated funds.

Capital Structure

The selection of a capital structure is a major element in the determination of rates and slight variations in the capital structure adopted for regulatory purposes may have significant impacts on a Company's revenue requirements. The capital structure is a financial concept which represents the sources of capital to the Company. Conceptually, the problem for the Commission was to identify what balance between the two major sources of capital, debt and equity, was appropriate for ratemaking purposes, being in the best interests of the Company and its ratepayers. The issue before the Commis-

sion thus becomes, what capital structure is reasonable for ratemaking purposes.

On the basis of the evidence in the record, the Commission finds that the RUD-AG has demonstrated that it would be most prudent and reasonable to use US West's consolidated capital structure for the purposes of determining an overall rate of return for NWB than to use NWB's projected actual post-divestiture capital structure as recommended by the Company. US West's consolidated capital structure consists of only its three regulated telephone company entities — NWB, Pacific Northwest Bell, and Mountain States.

The DPS argued that NWB's capital structure was inappropriate to use for regulatory purposes. In its place, the DPS recommended the use of a hypothetical capital structure containing 50% equity, 43.6% debt and 6.4% imputed debt. The DPS analysis merely demonstrated that NWB's capital structure was not equal to the composite groups its witness, Dr. Thompson, had chosen for comparison purposes. Dr. Thompson never demonstrated that NWB's capital structure was imprudent or unreasonable. The Commission is not convinced by the DPS's argument and has rejected similar arguments in NWB, P-421/GR-82-203 at 32, and *NWB*, P-421/GR-80-911 at 45.

The ALJ recommended the use of a hypothetical capital structure similar to the DPS's with slight modification to make the equity ratio equal to the level authorized in NWB's last rate case, *NWB*, P-421/GR-82-203. The Commission rejects the ALJ recommendation for the same reasons it rejected the DPS's recommendation.

NWB recommended that the Commission adopt its actual capital structure. NWB felt that the adoption of its own capital structure for the purposes of determining the overall rate of return recognized the affects of divestiture. The Company felt that in light of the AT&T break-up there was no longer a consolidated Bell System capital structure and hence it could not be used to set rates. The Commission agrees that since divestiture, the same Bell System consolidated capital structure that the Company advocated using in its last rate case (*NWB*, P-421/GR-82-203), no longer exists and therefore it would be impossible to use that capital structure. However, although the actual entity has disappeared, the principal of using the parent company's consolidated capital structure, which has

been the Commission's consistent practice in the last two NWB rate cases (*NWB*, P-421/GR-82-203, P-421/GR-80-911), did not disappear with Bell System consolidated capital structure. The Commission finds it reasonable and appropriate, therefore, to use the consolidated capital structure of US West, NWB's new post-divestiture parent, to determine the overall rate of return in this proceeding

The Commission finds the appropriate capital structure to consist of 43.85% debt and 56.15% equity. This is US West's consolidated capital structure which includes only the capital of its regulated telephone companies, NWB, Pacific Northwest Bell, and Mountain States, and also reflects the Commission's action earlier in this Order to void the transfer of yellow pages and directory services to US West (i.e. $23 million in equity is returned to NWB's capital structure and $23 million in short term debt is removed from its capital structure).

Cost of Debt

NWB argued in its Reply Brief, at 73, that if US West's capital structure was to be used, its embedded cost of debt must be used as well. This followed from the past practice of the Commission (most recently in *NWB*, P-421/GR-82-203) to apply AT&T's cost of debt to its consolidated capital structure when that structure was used to determine the overall cost of capital for its subsidiary, NWB. The Commission found this practice to be appropriate because the issuance of NWB's debt, although issued by the Company itself, was coordinated by AT&T. The Company, however, has argued, in its Initial Brief, at 129, that debt financing would not be coordinated on the integrated, system-wide basis, as it was in the old Bell System when AT&T was NWB's parent company. In fact, the Company has consistently argued in this proceeding that the realities of the post-divestiture environment demand that the focus be on NWB rather than the parent company in evaluating rate of return issues. In this instance, regarding the cost of debt, the Commission agrees with the Company that the focus should be on NWB and not its parent company. The Commission finds that the use of NWB's embedded cost of debt will reflect more correctly the influence of the Company's cost of debt on its actual operations.

However, due to the lack of actual Company figures on the embedded cost of debt and the lack of evidence on the record

demonstrating the effects of several transfers of equity and infusions of debt capital made by the Company in the course of this proceeding, the Commission finds that it has no alternative but to estimate NWB's embedded cost of debt.

The Commission observes that a cost of debt range exists on the record beginning with the last cost of debt figure agreed to by all parties (7.80% as of 1/1/84) prior to NWB's transfer of yellow pages and directory advertising services to US West and ending with 8.5% (the final updated cost of debt which reflects the debt issuance of $150 million in March, 1984). The Commission finds it reasonable to include the $150 million debt issue since it was known before the close of the record in this proceeding. However, there was some dispute over how that issuance affected NWB's embedded cost of debt. The Company did not provide actual numbers to substantiate its claim that the debt issue increased the Company's embedded cost of debt to 8.5%. In addition, the Commission, earlier in this Order, voided the transfer of $23 million in equity to US West for yellow pages and directory advertising. Concurrent with this equity transfer, the Company incurred $23 million in short term debt financing (which increased the Company's embedded cost of debt from 7.80% to 7.93%).

Since no actual numbers were provided by the Company to verify its constantly changing embedded cost of debt, the Commission cannot back-track to accurately remove the effect of the $23 million in short term debt to reflect the voided transfer, nor can it accurately reflect the effect of the $150 million in new debt. Therefore, it will adopt 8.15%, the average of 7.80% and 8.5% as an appropriate compromise cost of debt for regulatory purposes in this proceeding. The Commission also serves notice to the Company that it must provide, in future general rate proceedings before this Commission, the actual data used to calculate its embedded cost of debt. If during the course of such future proceedings, changes occur in the Company's amount of debt, the effect of such changes on the cost of debt shall also be accurately reflected with actual data.

Overall Rate of Return

Based on the findings and conclusions above, the Commission authorizes an overall rate of return of 11.71% for NWB, calculated as follows:

Source of Capital	% of Total Capital	Cost	Weighted Cost
Debt	43.85%	8.15%	3.57%
Equity	56.15%	14.50%	8.14%
	100.00%		
		Overall Rate of Return	11.71%

VIII. REVENUE DEFICIENCY

Based on the findings and conclusions in the preceding sections of the Order, the Commission authorizes a gross revenue increase of $57,511,000 as caluculated below:

	Dollars in Thousands
Average Test Year Rate Base	$1,023,132
Rate of Return Allowed	11.71%
Required Operating Income	$119,809
Test Year Operating Income	$95,454
Operating Income Deficiency	$24,355
Revenue Conversion Factor	2.2616
Company Revenue Deficiency	$55,081
Increased Toll Settlements	2,430
Total Rate Increase Authorized	$57,511

***

X. CORPORATE RESTRUCTURING

As stated in the Procedural History section of this Order, NWB presented a proposed Corporate Restructuring to the Commission on April 26, 1984. The Company stated that the restructuring was designed to comply with an FCC order (CC Docket No. 83-115 released on December 30, 1983). Notification to the Commission

preceeded by only several days the legal implementation of the reorganization. On May 4, 1984, the Commission issued an Order directing the DPS to investigate the corporate reorganization of NWB and affiliated corporations and to respond to specific Commission inquiries. *In the Matter of an Investigation by the Minnesota Public Utilities Commission into the Corporate Restructuring of Northwestern Bell Telephone Company*, Docket No. P-421/CI-84-192.

On May 14, 1984, a Post-hearing Conference was convened by the ALJ on his own motion to try to determine the extent to which the record in this rate case would reflect the business activities of the divested reorganized company during the period within which any revised rate may be in effect. As a consequence of the Post-hearing Conference, Motions to Dismiss were filed. The ALJ in a Recommendation dated May 22, 1984 recommended that the Commission grant the Motions to Dismiss.

On May 23, 1984, the Commission met to consider the ALJ's Recommendation. At that time the Commission established a schedule for Oral Argument on the Recommendation. The Commission viewed the Recommendation as a possible final disposition of a contested case proceeding which is governed by Minn. Stat. § 14.61 (1982). Oral Argument was held on June 5, 1984. In a letter dated June 8, 1984, the Commission requested that the ALJ write his Report on the existing record. The Commission also stated its intention upon rendering a decision on the record of this proceeding to move on its own motion for rehearing in all additional issues occasioned by the restructuring. The Commission indicated that the DPS would have the results of the Commission ordered investigation, and that the results could be used as the basis for additional hearings. The Commission also indicated that this process would provide all interested parties an opportunity to fully participate in the development of restructuring issues. The Commission cited Minn. Stat. § 237.075, subd. 2 (1982) as the source for its authority for ordering additional contested case proceedings on the impact, if any, of restructuring. That section provides in relevant part:

> If the Commission does not make a final determination concerning a schedule of rates within ten months after

the initial filing date, the schedule shall be deemed to have been approved by the Commission. For purposes of this section "final determination" means the inital decision of the Commission and **not any other which may be entered by the Commission in response to a petition for rehearing or other further relief. The Commission may further suspend rates until it determines all those petitions.** (Emphasis added)

The Commission recognizes that this rate case proceeding has been demanding of time, money and effort. Dismissal of the case would result in costs estimated to be $2-3 million which, if determined to be appropriate, would be allowable expenses in NWB's next rate case and would ultimately be borne by the Company's ratepayers. The Commission also realizes that there are many issues which may be unaffected by NWB's restructuring. Therefore, efficiency and economy demand that those issues and the record developed regarding them be preserved. For these reasons, the Commission will deny the Motions for Dismissal filed by the RFUJ, the SCAR, Evan J. Henry, the MPIRG, and the MSF.

Finally, the Commission finds that in order to protect the due process rights of the parties, each should receive the DFS report on the corporate restructuring of NWB and have an opportunity to comment on its findings and the manner in which those findings may affect the determinations made in this rate case. The Commission will so order. After receiving the DFS report and the comments of all parties, the Commission will establish any necessary procedures to address issues arising from the Company's reorganization.

ORDER

1. Northwestern Bell Telephone Company is entitled to increased gross annual revenues of $57,511,000 so as to produce total annual revenues of $649,468,000 from Minnesota intrastate operations.

2. Within 30 days of the service date of this Order, the Company shall file with the Commission for its review and approval, and serve upon all parties in this proceeding, revised schedules of

rates and charges determined in accordance with the total gross annual revenue requirement authorized in paragraph 1 above and the rate design decisions contained herein including the following:

a. The Company shall make no adjustment in its rate calculations for estimated curtailment or shift (repression) of its test year customer base.

b. For each local exchange service provided to both business and residential customers, the Company shall calculate the rates to establish a ratio of 3.0 to 1.0 between the rates for business and residential customers in each tier of the metropolitan exchange, and a ratio of 2.5 to 1.0 between the rates for business and residential customers in the outstate exchanges.

c. The Company shall calculate revised local exchange service rates to eliminate one-half of the difference in rate ratios for local exchange services provided in the metropolitan tier rate zones.

d. The Company shall increase rates for local measured services by the same percentage rates for single-party flat-rate business and residential local exchange services are increased.

e. The Company shall retain all metered local exchange services and increase rates for these services by the same percentage rates for single-party flat-rate business and residential local exchange services are increased.

f. The Company shall retain all multi-party local exchange services and shall increase rates for these services by the same percentage rates for single-party flat-rate business and residential local exchange services are increased.

g. The Company shall set the rates for semi-public coin telephone service at the same level calculated for single-party flat-rate business local exchange service.

h. The Company shall retain the PBX trunk rate designation and shall set the rates for this service at levels equal to

115% of the rates for single-party flat-rate business local exchange service.

i. The Company shall retain the multi-line rate designation for business and residential customers, and shall set rates for these services at levels equal to 105% of the corresponding rates for single-party flat-rate business and residential local exchange services.

j. The Company shall set the revised rates for centrex and group use exchange access lines at the sames levels calculated for PBX trunks.

k. The Company shall increase rates for extended area service by the same percentage single-party flat-rate business and residential local exchange services are increased.

l. The Company shall increase the surcharge for any operator assisted long distance calls presently providing a contribution of less than 25% to a level which will provide a 25% contribution.

m. The Company shall revise rates for touch-tone service provided in association with each category of local exchange service to reflect the rate changes authorized for those services. The Company shall eliminate the touch-tone charge applied to centrex extension stations and apply the same touch-tone rate to business 1-party flat rate local service and semi-public coin telephone service.

n. The Company shall increase rates for custom calling features to the levels it proposed in its initial filing except that it shall set the rate for the speed-calling 8 feature at $1 per month for customers who indicate that the feature is used by a physically or mentally impaired person.

o. The Company shall eliminate the 53¢ directory assistance credit and increase rates for calls to directory service as it proposed in its initial filing.

p. The Company shall increase rates for private line services not involved in the Revised Private Line Case as it pro-

posed in its initial filing.

q. The Company shall implement any other uncontested proposals as it proposed in its initial filing.

3. The Company shall provide, with the schedule of rates and charges referred to in paragraph 2 above, supporting documentation which demonstrates that the proposed schedule of rates will generate the level of revenues authorized in paragraph 1 above.

4. Within 30 days of the service date of this Order, the Company shall file with the Commission for its review and approval, and serve upon all parties in this proceeding, a proposed customer notice explaining the final prospective rates and surcharge, if any.

5. In the event that the Company seeks to implement a rate surcharge under the provisions of Minn. Stat. § 237.075, subd. 3 (Supp. 1983), the Company shall, within 30 days of the service date of this Order, file with the Commission for its review and approval, and serve upon all parties in this proceeding, a proposal whereby the Company will recover the difference between revenues collected from interim rates and the revenues from the rates authorized in this Order from the date of final determination to the date the new rate schedules are put into effect.

6. In the event that any party files a petition for rehearing or other post-hearing relief under Minnesota Rules, part 7830.4100, the time periods specified in paragraphs 2, 3, 4, and 5 above shall be extended to 30 days from the date of Commission decision on all such petitions.

7. Any party wishing to submit comments regarding the filings from paragraphs 2, 3, 4, and 5 above shall submit such comments to the Commission and all parties in this proceeding, in writing, within 10 days of service by the Company.

8. The Company shall, no later than December 31, 1984, submit to the Commission and serve upon all parties in this proceeding a rate proposal for exchange access service provided to customers using multiple line arrangements. The Company shall

submit, along with its rate proposal, a cost study of the additional costs it incurs to provide local exchange service to customers using multiple line arrangements. The Company shall, prior to beginning its cost study, discuss with the Department of Public Service, the Residential Utilities Division of the Office of the Attorney General, and any other party indicating an interest, the appropriate form and design of the cost study.

9. The Company shall, in all future rate case filings, identify the present and proposed test year revenues, and the present and proposed test year number of customers of revenue producing units, for all major categories of service provided to customers or exchange access provided to other carriers.

10. Within 30 days of the service date of this Order, the Company shall submit to the Commission and serve upon all parties in this proceeding a revised rate proposal for services provided to radio common carriers. Pending review of the revised rate proposal, the Company shall, subject to future adjustment, apply existing tariff or contract rates including compensation for intralata toll calls for all services provided to radio common carriers. Any party wishing to submit comments regarding the revised rate proposal shall submit such comments in writing to the Commission, and serve such comments upon all parties in this proceeding, no later than September 27, 1984.

11. The Motions for Dismissal filed by the Recipient Families United for Justice, the St. Cloud Area Ratepayers, Evan J. Henry, the Minnesota Public Interest Research Group and the Minnesota Senior Federation are hereby denied.

12. The Department of Public Service shall, no later than August 1, 1984, submit to the Commission, and serve upon all parties in this proceeding, a report of its investigation regarding the reorganization of Northwestern Bell Telephone Company undertaken *In the Matter of an Investigation by the Minnesota Public Utilities Commission into the Corporate Restructuring of Northwestern Bell Telephone Company*, Docket No. P-421/CI-84-192. Any party wishing to submit comments regarding the DPS report shall submit such comments in writing to the

Commission, and shall serve such comments upon all parties in this proceeding, no later than August 14, 1984.

13. The Company shall maintain a separate acounting of all additional revenues received resulting from the treatment of JDIC allowed by the Commission in computing income tax interest expense for ratemaking purposes in this jurisdiction.

14. The transfer of directory operations and associates assets from Northwestern Bell Telephone Company to U. S. West Direct is hereby declared null and void. The directory operations and associated assets shall be returned to and retained by Northwestern Bell Telephone Company.

15. Within 30 days of the service date of this Order, the Chief Executive Officer of Northwestern Bell Telephone Company shall submit an affidavit to the Commission stating that all directory operations and associated assets have been returned to Northwestern Bell Telephone Company. The affidavit should include a description of the execution and the accounting of this transaction.

16. The Company shall make an annual report regarding the revenues, expenses, and investments associated with the provision of directory operations. In order to comply with this reporting requirement the Company shall, within 30 days of the service date of this Order, submit to the Commission for its review and approval and serve upon all parties to this proceeding, a plan for separately accounting for all revenues, expenses, and investment associated with the provision of all directory operations. Any party wishing to submit comments regarding this plan shall submit such comments in writing to the Commission, and shall serve such comments on all parties in this proceeding within 10 days of service by the Company.

17. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Randall D. Yong
Executive Secretary

SERVICE DATE: July 27, 1984

(SEAL)

APPENDIX 3

BEFORE THE
MINNESOTA PUBLIC UTILITIES COMMISSION

Leo G. Adams	Chairman
Harry Seymour Crump	Commissioner
Roger L. Hanson	Commissioner
Terry Hoffman	Commissioner
Cynthia A. Kitlinski	Commissioner

Docket No. P-421/CR-83-600

In the Matter of the Application of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota

ORDER AFTER RECONSIDERATION AND REHEARING

Procedural History

On September 29, 1983, Northwestern Bell Telephone Company (Northwestern Bell, NWB or the Company) filed a petition for increased rates with the Minnesota Public Utilities Commission (the Commission), pursuant to Minn. Stat. § 237.075 (Supp. 1983).

The Commission accepted NWB's filing and suspended the proposed rates by Order dated October 21, 1983. On that same date, the Commission issued its Notice and Order for Hearing directing that a hearing be conducted on the Company's petition. Administrative Law Judge Bruce D. Campbell (ALJ) was assigned to the proceeding by the Office of Administrative Hearings.

The ALJ conducted evidentiary hearings in St. Paul on January 9, 10–13, 16–20, 23–27 and 30, 1984; March 12–16, 19–23, 26 and 27, 1984; and April 5, 1984.

On April 26, 1984, Northwestern Bell presented to the Commission a proposed corporate restructuring. As part of its presentation,

NWB provided documents which it had filed before the Federal Communications Commission (the FCC) which were designed to comply with an FCC order (CC Docket No. 83-115, released on December 30, 1983). The FCC, in that order, imposed the structural separation requiremnets of 47 C. F. R. § 64.704 on the divested Bell Operating Companies (BOCs) in their offering of customer premises equipment (CPE) and enhanced services if they intended to provide such services after the divestiture. NWB is one of the 22 divested BOCs.

In its presentation before the Commission, NWB informed the Commission that to comply with the FCC's December 30, 1983 Order it would incorporate a new holding company, Northwestern Bell Corporation on April 30, 1984. Northwestern Bell Corporation would have as its subsidiaries Northwestern Bell Telephone Company (NWBT), and Northwestern Bell Information Technologies, Incorporated. NWBT would encompass all present operations of NWB and would be regulated by the Commission. Northwestern Bell Information Technologies, Incorporated would be a new company formed on May 3, 1984, and would not be regulated by the Commission.

On May 4, 1984, the Commission issued an order directing the Minnesota Department of Public Service (DPS) to investigate the corporate reorganization of NWB and affiliated corporations and to respond to specific Commission inquiries *In the Matter of an Investigation by the Minnesota Public Utilities Commission into the Corporate Restructuring of Northwestern Bell Telephone Company*, Docket No. P-421/CI-84-192.

On May 14, 1984, a Post Hearing Conference was convened by the ALJ on his own motion to try to determine the extent to which the record in this rate case would reflect the business activities of the divested reorganized company during the period within which any revised rate may be in effect.

Pursuant to written Motions, dated May 16, 1984, the following parties to the above-captioned proceedings timely requested that the ALJ recommend to the Commission a summary disposition or dismissal of the pending general rate increase requested by Northwestern Bell: the DPS; the Recipient Families United for Justice (RFUJ); the St. Cloud Area Ratepayers (SCAR); Evan J. Henry; the Minnesota Public Interest Research Group (MPIRG); and the

Minnesota Senior Federation (MSF). Such Motions were accompanied by supporting memoranda of law. On May 17, 1984, the DPS entered into a Stipulation with Northwestern Bell (Stipulation), and formally withdrew its previous Motion to Dismiss. On May 18, 1984, Northwestern Bell timely filed a memorandum of law opposing the Motions to Dismiss.

The ALJ submitted the Recommendation of Administrative Law Judge Regarding Motions for Summary Disposition or Dismissal to the Commission on May 22, 1984. The ALJ recommended that the application of NWB for authority to change its schedule of telephone rates for Minnesota customers be dismissed for failure of the Company to sustain its statutory burden of proof. Minn. Stat. § 237.075, subd. 4 (Supp. 1983).

On May 23, 1984, the Commission met to consider the ALJ's Recommendation of Dismissal. The Commission viewed the Recommendation as a possible final disposition of a contested case proceeding. Minn. Stat. § 14.61 (1982) provides that in a contested case a final decision cannot be made until the report of the ALJ has been made available to parties for at least 10 days and affords an opportunity for adversely affected parties to file exceptions and present oral argument. Consequently, Oral Argument on the ALJ's Recommendation for Dismissal was held on June 5, 1984. The following parties participated in the Oral Argument: MPIRG, MSF, RFUJ, SCAR, NWS, DPS, Minnesota Business Utility Users Council (MBUUC), and the Residential Utilities Division of the Office of the Attorney General (RUD—AG).

On June 8, 1984, the Commission sent a letter to the ALJ stating that due process would best be served by addressing the restructuring issue within the context of this proceeding. The letter stated that the Commission intended, upon rendering a decision on the record of this proceeding to move on its own motion for rehearing on all additional issues occasioned by the restructuring. The Commission requested that the ALJ issue his Report on the basis of the existing record.

The ALJ submitted his Report to the Commission in two parts on June 19 and June 26, 1984. The Commission heard Oral Argument on July 9, 1984.

The Commission issued its Findings of Fact, Conclusions of Law and Order on July 27, 1984 (July 27, 1984 Order), authorizing a

rate increase of $57,511,000 exclusive of the test year effects of the corporate restructuring that occured on or about April 30, 1984.

Petitions for Reconsideration or Rehearing of the July 27, 1984 Order were filed by the RUD-AG and NWB on August 6, 1984; by the Minnesota Radio Common Carriers Association (MRCCA), NewVector Communications, Inc. (NewVector), the DPS, and Evan J. Henry on August 16, 1984.

The Company filed Replies to the Petition of the RUD-AG on August 16, 1984 and to the Petitions of the DPS, the MRCCA, NewVector, and Evan J. Henry on August 28, 1984. The RUD-AG and the DPS filed Responses to the Company's Petition for Reconsideration on August 17, 1984. On that same date, the MBUUC filed its Response to the RUD-AG's Petition for Reconsideration.

The July 27, 1984 Order directed the DPS to submit to the Commission and serve upon all parties to this proceeding a report of its investigation regarding the corporate reorganization of NWB undertaken in *NWB*, P-421/CI-84-192. Any party wishing to submit comments regarding the DPS report was directed to do so in writing to the Commission and serve them on all parties no later than August 14, 1984.

On August 1, 1984, the DPS Report in *NWB*, P-421/CI-84-192 (August 1, 1984 Report) was submitted to the Commission and served upon all parties to this proceeding. Comments were filed by the RUD-AG and NWB on August 14, 1984. Neither Mr. Henry, nor any other party, submitted comments. In the August 1, 1984 Resport, the DPS indicated its preliminary findings that the $57,511,000 rate increase authorized in the July 27, 1984 Order should be reduced by $371,000 to reflect the financial impact of the Company's reorganization pertaining to the test year used in this proceeding. The DPS indicated that the $371,000 reduction was a preliminary adjustment which it would subsequently revise to conform with the Commission's findings in the July 27, 1984 Order. On August 24, 1984, the DPS submitted to the Commissin and served upon all parties to this proceeding its revised adjustment of $363,000.

In an Order dated August 27, 1984, the Commission ordered a rehearing in this proceeding. Rehearing was granted for the limited purposes of: 1) receiving the DPS August 1, 1984 Report resulting

from its investigation in *NWB*, P-421/CI-84-192 into the record of this proceeding; 2) determining whether there was cause to go forward to a contested case proceeding regarding the financial impact of NWB's corporate restructuring on this proceeding.

Oral Argument on Petitions for Reconsideration of the July 27, 1984 Order was held on September 11, 1984.

On September 12, 1984, the Commission held a rehearing to receive the DPS August 1, 1984 Report into the record of this proceeding, and to determine whether there was cause to go forward to a contested case proceeding regarding the financial impact of NWB's corporate restructuring on this proceeding.

Supplemental Findings of Fact and Conclusions of Law

The Commission has given limited reconsideration to its July 27, 1984 Order regarding rates for radio common carriers, and amended the final revenue requirement to recognize the test year effects of Northwestern Bell's corporate reorganization.

In addition, the Commission has made supplemental findings regarding the following issues:

1. The transfer of investment tax credits from NWB to American Telephone and Telegraph Company (AT&T);
2. The directory operations;
3. Various isues raised by Evan J. Henry;
4. The rates for radio common carriers;

Further, the Commission has granted a limited stay of its July 27, 1984 Order requiring restoration of directory operations to NWB upon the petition of NWB.

The Commission finds that all other issues raised in the various Petitions For Reconsideraton have been carefully considered by the Commission as discussed extensively in the July 27, 1984 Order, and that no new arguments or evidence have been presented by the parties. Therefore, the Commission concludes that reconsideration should be denied on all other issues not expressly discussed in this Order.

The Commission will also address the test year financial effects

of Northwestern Bell's corporate restructuring.

***

IV. Test Year Effect of Corporate Restructuring

In its of July 27, 1984 Order, the Commission ordered the DPS to serve upon all parties in this proceeding by August 1, 1984, a report of its investigation undertaken in *NWB*, P-421/CI-84-192 regarding NWB's corporate restructuring. The July 27, 1984 Order also provided all parties the opportunity to submit written comments on the DPS report no later than August 14, 1984.

The DPS submitted its Report on August 1, 1984. That Report indicated that the effect of the corporate restructuring was to reduce the Company's revenue deficiency in this proceeding by $371,000. The Company and the RUD-AG filed written comments in regard to the DPS report. Neither party contested the DPS report with regard to the impact of the restructuring upon the test year revenue deficiency. Mr. Henry, did not submit comments.

On August 24, 1984, the DPS served a memorandum on all parties which calculated the amended effect of the corporate restructuring as a downward adjustment of $363,000 to the rate increase authorized by the Commission in its July 27, 1984 Order. The amended calculation reflected the cash working capital impact of the adjustments to the test year income statement and the lower rate increase. The revised adjustment also reflected an amendment to the pro forma interest expense and the use of the Commission's allowed rate of return.

On August 27, 1984, the Commission issued its Notice and Order for Rehearing. The following parties appeared at the Rehearing on September 12, 1984: NWB, the DPS, the RUD-AG, MPIRG, Evan J. Henry, and the Department of Defense and the Federal Executive Agencies. None of the parties disputed the accuracy of the $363,000 downward adjustment to the authorized rate increase as set forth in the DPS memorandum of August 24, 1984 or requested further hearings on this matter.

The Commission finds that the previously authorized rate increase of $57,511,000 should be reduced by $363,000 to reflect the test year impact of NWB's corporate restructuring upon this proceeding as outlined in the DPS August 1, 1984 Report, and the DPS memo-

randum of August 24, 1984. The Commission concludes that the Company should be granted a gross revenue increase of $57,148,000, and that further hearings on the test year effect of the corporate reorganization are not required.

***

Order

1. Order paragraph 1 of the Commission's July 27, 1984 Order in this proceeding is hereby amended as follows in order to reduce the previously authorized increase in gross annual revenues of $57,511,000 to recognize the $363,000 adjustment proposed by DPS to reflect the test year effects of Northwestern Bell Telephone Company's corporate reorganization:

   1. Northwestern Bell Telephone Company is entitled to increased gross annual revenues of $57,148,000.

2. Order paragraph 10 of the Commission's July 27, 1984 Order in this proceeding is amended as follows:

   10. Within 30 days of the service date of this Order, the Company shall submit to the Commission and serve upon all parties in this proceeding a revised rate proposal for services provided to radio common carrier. Pending review of the revised rate proposal, the Company shall apply rates determined under prior contractual agreements for service provided all conventional radio common carriers as permanent rates, shall apply proposed Feature Group A & E rates for services provided to NewVector as permanet rates, and shall apply the rates originally proposed in *NWB*, P-421/M-84-189 for services provided to MCI/Cellcom Cellular as interim rates.

3. Order paragraphs 14 & 15 of the Commission's July 27, 1984 Order in this proceeding are hereby stayed for a period of 30 days from the effective date of this Order. In the event Northwestern Bell Telephone Company undertakes a court appeal of the Commission's determinations regarding directory operations

as set forth in order paragraphs 14 and 15 of the July 27, 1984 Order in this proceeding, the stay of order paragraphs 14 & 15 shall be extended until such time as the appeal is decided by the courts.

4. Northwestern Bell Telephone Company's request for a stay of order paragraph 16 of the Commission's July 27, 1984 Order in this proceeding is hereby denied. However the time limits specified in the July 27, 1984 Order shall run from the service date of this Order.
5. The Petitions for Reconsideration of Northwestern Bell Telephone Company, the Residential Utilities Division of the Office of the Attorney General, the Minnesota Radio Common Carrier Association, NewVector Communications, Inc., and the Department of Public Service are hereby denied in all other respects.
6. The Petition for Reconsideration and Oral Motions for Dismissal of Evan J. Henry are hereby denied in all respects.
7. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Randall D. Young
Executive Secretary

SERVICE DATE: September 26, 1984

(SEAL)

APPENDIX 4

BEFORE THE
MINNESOTA PUBLIC UTILITIES COMMISSION

Harry Seymour Crump	Chairman
Barbara Beerhalter	Commissioner
Cynthia A. Kitlinski	Commissioner
Robert J. O'Keefe	Commissioner

Docket No. U-999/CI-86-177

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners

ORDER INITIATING INVESTIGATION

FINDINGS AND CONCLUSIONS

On February 19, 1986, the Minnesota Public Utilities Commission (the Commission) issued an Order Vacating December 30, 1985 Order, Dismissing General Rate Case, Discontinuing Interim Rates, and Requiring Refund of Interim Rates in *In the Matter of the Petition of Northern States Power Company for Authority to Change its Schedule of Gas Rates for Retail Customers within the State of Minnesota,* Docket No. G-002/GR-85-108 and *In the Matter of the Proposal of Northern States Power Company for Recovery of Gas Conservation Expenditures,* Docket No. G-002/GR-85-282 (NSP Gas Case). In its February 19 Order the Commission found that improper contacts had occurred between former Commissioner Leo Adams and Northern States Power Company (NSP or the Company) while the Commission was deciding the NSP Gas Case. The Commission determined that NSP's contacts with Commissioner Adams concerning NSP's future employment of Adams had the effect of tampering with the Commission's delibera-

tions in the NSP Gas Case and impairing the integrity of the administrative process.

In an affidavit which was received into the record of the NSP Gas Case, former Commissioner Adams stated: "On October 15, I sent copies of an updated resume to several companies in Minnesota including NSP." This raised the further question whether Adams may have had improper contacts with other Minnesota companies regulated by the Commission while he was a member of the Commission.

Newspaper reports have also disclosed that former Commissioners Juanita Satterlee and Roger Hanson engaged in employment discussions with companies regulated by the Commission while they were members of the Commission. The Federal Bureau of Investigation and the Ramsey County Attorney's Office have reportedly begun criminal investigations into the matter of utility and telephone company contacts with Satterlee, Hanson, and Adams to determine if any criminal laws have been violated.

The Commission believes that it is also necessary to investigate and identify any other Commission decisions that may have been adversely affected by improper contacts between regulated companies and Satterlee, Hanson, and Adams. The Commission will be able to use this investigation to remedy any past decision influenced by improper contacts. Thus, the Commission concludes that an investigation of improper contacts between regulated companies and Satterlee, Hanson, and Adams is appropriate.

The Commission is aware that the Minnesota Department of Public Service (the DPS) has initiated its own investigation into similar matters arising from Commissioner contacts with utilities and telephone companies.

The Commission is authorized by Minn. Stat. §§ 216B.21 and 237.081 (1984) to initiate its own investigation and by Minn. Stat. § 216A.095 (1984) to jointly conduct investigations with the DPS. The Commission may set the scope for its own investigation and ask the DPS to carry out such investigation.

The Commission finds that any investigation relating to the Commission, utilities or telephone companies it regulates should be conducted independently of the Commission to insure public faith in the integrity of the investigation. The Commission further finds that duplicating the DPS's efforts in conducting this investigation

would waste Commission resources and thus would not be in the public interest.

The Commission will initiate its own investigation and direct the DPS to act independently of the Commission in carrying out the investigation. The Commission will equip the DPS with the full powers the Commission now possesses for conducting this investigation. The opening of the Commission investigation is not intended to require the DPS to conduct an investigation different from the independent investigation of the DPS currently underway. Rather, the Commission ratifies and endorses the DPS investigation subject to the directions below. First, the Commission will direct that the investigation cover at least the last several months of the Commission terms of Satterlee, Hanson, and Adams. Second, the Commission will direct the DPS to investigate whether any improper communications occurred during proceedings addressing issues of significant financial impact to regulated companies or addressing issues of significant policy issues likely to lead to a significant financial impact on regulated companies. To assist the investigation, the Commission will provide the DPS with a list of significant Commision decisions. The Commission will aid the DPS in any other appropriate way upon the request of the DPS.

The Commission emphasizes that none of the actions it will be directing the DPS to do are intended to limit in any way the scope of the investigation. The Commission will further direct the DPS to pursue all avenues it determines to be appropriate for a full and independent investigation.

The Commission will also direct the DPS to provide the Commission with a *full report* of the investigation promptly upon its completion so the Commission may determine whether remedies are required to further assure or improve the integrity of the regulatory process.

ORDER

1. The Commission initiates its own investigation and directs the DPS to act independently of the Commission in carrying out the investigation. The Commission confers upon the DPS all the legal powers the Commission now possesses for conducting this investigation.

2. The DPS investigation for the Commission shall cover at least the last several months of the Commission terms of Juanita Satterlee, Roger Hanson, and Leo Adams. The investigation shall be sufficient in scope to assess whether any improper communications occurred during Commission proceedings addressing issues of significant financial impact to regulated companies or addressing significant policy issues likely to lead to a significant financial impact on regulated companies. These are minimum requirements for the scope of the investigation and are not meant in any way to limit the scope of the investigation.

3. The DPS shall pursue all avenues it determines to be appropriate for a full and independent investigation.

4. The DPS shall provide the Commission with a full report of the investigation promptly upon its completion.

5. This Order shall be effective immediately.

BY ORDER OF THE COMMISSION

Mary Ellen Hennen
Executive Secretary

APPENDIX 5

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners

REPORT OF THE DEPARTMENT OF PUBLIC SERVICE TO THE MINNESOTA PUBLIC UTILITIES COMMISSION

I. INTRODUCTION

In January and February, 1986, three former members of the Minnesota Public Utilities Commission, Leo Adams, Juanita Satterlee and Roger Hanson, acknowledged negotiating consulting contracts with regulated utilities while still serving on the Commission. In addition, Hanson acknowledged Northwestern Bell Telephone Company (NWB) had paid him approximately $40,000 for consulting services during the eleven month period between the expiration of his term in Jaunary, 1985 and his reappointment to the Commission at the end of November, 1985.

The Minnesota Department of Public Service (Department) initiated an investigation into the timing and nature of these employment negotiations to determine whether they created conflicts of interest affecting the integrity of the Commission's adjudicatory function. The Department also examined Hanson's consulting arrangement with NWB and its possible effects on decisions he subsequently made as a commissioner. The investigation was conducted pursuant to the authority of the Director of the Department, Minn. Stat. § 216A.07, subd. 1(4), subd. 4. On April 9, 1986, the Commission issued an order directing the Department to continue its own independent investigation and conferring upon the Department the Commission's own investigatory authority.

The Department's investigation into NWB's consulting arrangements with former Commissioners Hanson and Satterlee also revealed a pattern of contacts between NWB's then Assistant Vice

President in charge of regulatory affairs, Roy Weir, and the three former commissioners. Weir's expense records showed he had regular meals with the commissioners, more frequently with Hanson and Adams, and he billed these meals to NWB. These contacts continued and, in some cases, even increased in frequency when NWB had contested matters before the Commission. The Department made a careful examination of these contacts in an attempt to determine whether matters pending before the Commission were discussed.

II. OBJECTIVE AND PURPOSE

The Department's objective in investigating both the employment negotiations and the pattern of contact between NWB and the three commissioners was to ascertain:

1. Which, if any, Commission decisions had been tainted by employment negotiations or arrangements on the part of a commissioner and a regulated utility;

2. The appropriate remedies for proceedings which are tainted;

3. Whether certain actions created an appearance of impropriety jeopardizing the public trust in the Commission; and

4. The steps necessary to eliminate the possibility of similar occurrences in the future.

III. SCOPE

The Department's investigation focused on the following areas:

1. The timing and nature of former Commissioner Satterlee's discussions with NWB representatives regarding a consulting arrangement with that company.
   Time: specific; March 1983–July 1983, and
   general; November 1982–January 1984.

2. The timing and nature of former Commissioner Hanson's negotiations and consulting arrangement with NWB, which involved

payments by NWB through a third party, attorney Robert Johnson.

Time: specific; November 1984–January 1985, and general; November 1984–January 1986.

3. The timing and nature of former Commissioner Adams' efforts to secure employment from regulated companies prior to the expiration of his term.

   Time: July 31, 1985–January 1986.

4. The pattern of contact between NWB and the three commissioners through regular meals at NWB's expense.

   Time: November 1982–October 1983, and April 1984–December 1984.

This report is the result of the Department's investigation and is comprised of the following four sections: Methods; Summary of Facts; Discussion of Issues and Applicable Legal Standards; and Recommendations to the Commission. In addition, the depositions and documents obtained in the course of the investigation are made supporting exhibits to the report to enable the Commission to make an independent evaluation of the facts.

IV. METHODS

There were two parts to the Department's investigation. The first was examination of proceedings during the times when commissioners were engaged in employment negotiations or arrangements. This part was conducted through a review of the Commission actions compiled by both the Department and the Commission. Ex. 15. The second, and more complicated, part was examining the conduct of the affected utilities and the three commissioners.

The Department began its investigation into the negotiations and consulting arrangements of Hanson and Satterlee with letters to NWB asking for the details of these arrangements and for underlying documentation. After receiving NWB's responses, the Department determined it was necessary to depose people with material knowledge about the arrangements. The Department issued subpoenas to Thomas Madison, Roy Weir, Juanita Satterlee, Roger Hanson, Robert Johnson, Leo Adams and Christopher Sandberg. A NWB attorney was allowed to be present at the depositions and to

cross-examine witnesses. Witnesses were also allowed to have their own attorney present at the depositions. The Department informally interviewed other witnesses and secured affidavits from those with material information.

The Department issued subpoenas for documents from NWB and the individual deponents. These subpoenas included a request for all documentation reflecting or pertaining to Assistant Vice President Weir's contacts with the commissioners. In response to the subpoenas, NWB made available, and Department representatives inspected, documents pertaining to Weir's work before the Commission including Weir's expense records. Weir represented, however, that all of his personal calendars were destroyed when he left NWB's employ. W-41.

During the course of the investigation, NWB asserted that all of the documents produced in the investigation, including expense reports, portions of the deposition transcript and informational letters, were trade secret or security information under the Data Practices Act and must be kept confidential after the report was issued to the Commission. Pursuant to Department procedures, the Department determined that only three of the documents produced by NWB were properly classified as security information because they detailed NWB's accounting procedures and listed NWB's internal computer codes. The Department also determined that four internal memoranda were properly classified by NWB as trade secret data. The Department informed NWB on June 10, 1986 that the remaining documents would be classified as public when the Department closed its investigation. Ex. 68.

During the course of the investigation NWB also served interrogatories and a Request for Production of Documents upon the Department. Because NWB requests were not authorized by state law and some requests were irrelevant to the investigation, the Department did not provide the information or documents requested. Ex. 77. However, all relevant documents are being made available to NWB with this report.

When investigating the negotiations between Commissioner Adams and Northern States Power Company (NSP) in January 1986, the Department developed the factual record by requesting information from the company in writing and obtaining a formal written response. The facts of these negotiations are fully set forth

in the Department's motion to dismiss and the Commission's subsequent order dismissing NSP's gas rate case (G002/GR-85-108). Ex. 8. In this investigation the Department examined Adams' job inquiries with other regulated utilities both by deposition questioning and by sending a letter to companies with significant decisions pending before the Commission during the time of Adams' inquiries. These letters requested specific information as to the timing and nature of Adams' employment inquiries. The Department has received a response to each of its investigative letters.

Determining any charges of violations of criminal law are beyond the jurisdiction of the Department and Commission. The Department, therefore, has transmitted copies of all collected pertinent data to the Ramsey County Attorney's Office which is conducting its own investigation.

With few exceptions, the Department has had to rely on the testimony of the former commissioners and NWB representatives in sorting out the contacts between them. In the fact section which follows, the Department has attempted to summarize the factual information contained in the depositions and documents. In addition to considering the findings and recommendations of this report, the Commission is urged to make an independent review of the underlying documentation in assessing the Department's recommendations.

The deposition transcripts are designated as follows:

Satterlee deposition	— S
Hanson deposition	— H
Madison deposition	— M
Weir deposition	— W
Johnson deposition	— J
Adams deposition	— A
Sandberg deposition	— CS

Citation to deposition exhibits refer to exhibits appended to the designated deposition transcript. Other, non-deposition exhibits are identified by exhibit number.

V. SUMMARY OF FACTS

A. EMPLOYMENT NEGOTIATIONS AND CONSULTING ARRANGEMENTS

1. Commissioner Juanita Satterlee

Juanita Satterlee's initial six-year term with the Commission expired in January, 1983. In the fall of 1982, Commissioner Satterlee sought reappointment to a second term. She testified, however, that she had decided at that time not to serve a full term if reappointed. S-26. In November, 1982, the Governor-elect's office informed Satterlee that she would be reappointed to the Commission. S-36. Satterlee stated in her deposition that in January and February of 1983, she was thinking about other employment options, including consulting, and that she discussed these options with her family. S-30-31.

According to Weir's expense records, Satterlee met with him for meals on twelve occasions during February, March and April of 1983.[1] She testified she did not recall discussing her plans to leave the Commission or her idea of trying consulting during those meetings with Weir. S-26-40. Three issues she does recall discussing with Weir during that time were the closing of NWB's business offices around the state, obtaining legislative authority to compensate intervenors in Commission cases, and individual complaints about NWB service. S-34. Other than these issues, she does not recall the substance of her conversations with Weir at those meetings. S-39.

According to his expense records and personal calendar, Thomas Madison, then Vice President and Chief Executive Officer of Minnesota for NWB, met with Satterlee on March 9, 1983. Madison and Satterlee both maintain that they had no discussions about possible employment or consulting arrangements at that meeting, M-50, S-58, although they did discuss issues similar to those Satterlee advised NWB on after becoming a consultant for the utility. S-54. Satterlee recalls that the purpose of the meeting was to discuss the closing of NWB outstate business offices and that they also discussed the Lieutenant Governor's race in the electoral campaign of the previous year. S-57. Madison recalls discussing both the business office closings and the election. Madison's expense records

[1]Satterlee disputes the accuracy of some of the entries in Weir's expense records. S-33.

indicate that they discussed the impact on NWB of legislative activities. Madison Depo. Ex. 6. Madison recalls discussing "something" about the legislature but does not remember what it was. M-55-56.

On April 27, 1983, Satterlee met with the Governor and attempted to submit her resignation. Satterlee said she told the Governor at the meeting that she was probably going into the consulting business. S-48. Satterlee testified that even though she intended to resign immediately after the April 27 meeting, she had no firm plans for post-commission employment. The Governor asked her to take some time to think about her decision and did not accept her resignation that day. S-49, 50. Satterlee subsequently took a leave of absence beginning in late May until early July while she and her family traveled in Europe. She resigned from the Commission July 12, 1983. Her last day as a commissioner was July 29, 1983.

Madison indicated that although he does not remember the exact timing, he learned from Weir close to the time of Satterlee's April 27, 1983 meeting with the Governor that she was leaving the Commission and was interested in becoming a consultant. M-58-61. Satterlee says she did not tell Weir that she intended to leave the Commission until after he meeting with the Governor. S-48. She also believes she talked to Madison regarding possible consulting with NWB after April 27, but she does not recall whether she talked to Weir or Madison first. S-66. Weir testified he learned from the newspaper at the end of April that Satterlee was leaving the Commission. W-107. Sometime after that he discussed with Satterlee her idea about going into the consulting business. W-107-108. Weir stated that after he talked to Satterlee he talked to Madison about her intention to resign. W-110.

According to Madison and Satterlee, sometime after the April 27 meeting and before May 20, they talked about the possibility of Satterlee performing consulting work for NWB. S-70-71. During the conversation Madison told Satterlee to put something in writing for his review. Satterlee stated that after this conversation with Madison she contacted Christopher Sandberg about drafting a consulting contract. S-65. Sandberg is an attorney and at that time worked as a Legal Research Analyst II with the Commission. He testified that he also worked privately out of his home on relatively small and uncomplex legal matters on his own time. CS-6. It was

in this private capacity that Satterlee asked Sandberg to prepare a general consulting agreement for her which would contain enough specifics to be used in discussions with NWB. CS-15. She also asked him to prepare a will because she was going on vacation to Europe near the end of May. CS-20.

At her deposition, Satterlee produced two checks dated April 28, 1983 and May 23, 1983, which she stated were the only payments she made to Sandberg for legal work in the spring of 1983. S-59-60. Sandberg's recollection of the circumstances surrounding his receipt of these checks places the date when Satterlee first approached him about drafting the consulting agreement a number of weeks earlier than April 27, 1983.

Sandberg prepared a will dated May 24, 1983. The consulting agreement he prepared survives only as an undated draft. CS-17. Sandberg stated that he believed, although he was not certain, the May 23, 1983 check was for the will he prepared because he was not asked to prepare the will until, at the most, two weeks before it was executed and he recalls being paid near the date of execution, which was May 24, 1983. CS-23. Based on the circumstances, Sandberg believes the April 28, 1983 check was for the consulting agreement he prepared for Satterlee. CS-24. Satterlee could not recall which check was made in payment for which document. S-62-64.

Sandberg's impression was that Satterlee's conversation with Madison had been quite close to the time she discussed the contract with him, within a week or less. CS-16. Sandberg recalls Satterlee approached him about preparing the consulting agreement sometime in late April or early May. CS-9. Sandberg also recalls, however, that it took "a couple of weeks" to prepare the consulting agreement because he prepared five separate drafts. After each draft he would consult with Satterlee before preparing the next. CS-16. He believes he was paid by check when he completed either the last or about the last draft. CS-18. If Sandberg's recollection about the circumstances of his receipt of these checks is correct, then Satterlee would have had to approach Sandberg in the first half of April about preparing the consulting agreement.

Satterlee and Madison both testified that they met on May 20, 1983, at the Chocolate Mousse Restaurant in St. Paul, and Satterlee gave the draft agreement to Madison at that time. Neither

recalls when or how the meeting was scheduled. S-107, M-66. Both stated that they did not discuss the draft contract during their meeting, rather they discussed more general issues facing NWB. S-107, M-67. Madison stated he did not consider Satterlee's proposal polished, but told Satterlee they would talk further when she returned from Europe. M-69. Satterlee left for her European vacation around May 25, 1983. She resigned from the Commission on July 12, 1983 after she returned from Europe.

In a letter to the Department dated February 28, 1986 regarding the Satterlee consulting arrangement, NWB represented that Madison showed Satterlee's draft proposal to NWB's general attorney, James Gallagher, after the May 20 meeting. Gallagher recalls meeting with Madison in late May. Among the concerns Gallagher expressed in the meeting, was that "as a practical matter and from an appearance standpoint, NWB should not engage in negotiations with Satterlee regarding future consulting while she was a Commissioner, that NWB should not enter into a consulting agreement with her until some reasonable period after she left the Commission (Gallagher suggested January, 1984) and that in the event an agreement was later negotiated it would be advisable to have Satterlee work on matters on behalf of NWB in states other than Minnesota." Madison Depo. Ex. 7, p. 7.

In the spring of 1983. NWB had three significant matters before the Commission. On April 4, 5 and 6 the Commission deliberated and voted on NWB's request for a rate increase of $89,974,080.00, Commission Docket No. P421/GR-82-203, (hereinafter referred to as 82-203). The final vote on the 82-203 order was entered on April 20, 1983. Ex. 79. The Commission denied the petition for reconsideration on May 26, 1986. On May 4, 1983, the Commission voted to permanently authorize the resale of measured WATS and to continue prohibiting resale of full-time WATS, Commission Docket No. P421/82-619; P421/M-83-127 (hereinafter referred to as WATS resale). Ex. 90. In addition, on May 17, 1983, the Commission made its decision in the Basic Six Resale Rates matter, Commission Docket No. P421/M-83-144 (hereinafter referred to as Basic Six). Ex. 84. Basic Six involved setting resale rates for most common telephones which NWB had previously rented to consumers. In all three of these cases, the Commission rendered decisions on disputed issues. Satterlee did not participate in the Commission

deliberation on 83-203 or the vote on reconsideration. She did vote to approve the final order. She also participated in the Basic Six and WATS Resale votes which unanimously favored the company's position.

Madison's expense records and personal calendar indicate a meeting took place at NWB's Minneapolis office between Satterlee and Madison on August 5, 1983. Madision testified he recalled discussing what input Satterlee could have into garnering wider acceptance for local measured service. M-69-70. Madison's testimony is at some variance with NWB's February 28, 1986 letter to the Department which states Madison "attempted to learn from Satterlee what ideas she had as to how she could be of use to NWB in assisting NWB in gaining a better understanding of how the Company is perceived by consumers and how the company can obtain and better utilize consumer input in its decision-making." Madison Depo. Ex. 7, p. 7. Satterlee does not recall this meeting, but assumes the meeting was held. S-110.

During the months of August and September, 1983, Satterlee stated that she was thinking about other employment options but did not pursue any of them. S-111-112. She stated that on September 1, she was "still dickering" with NWB over her possible work for them. S-112, 113. In September she met with Weir and Gene Bier, who had replaced Madison as NWB's Chief Executive Officer in Minnesota, to discuss her possible role as a consultant. Weir stated in his deposition that, even though he had met with Satterlee on several occasions since April, 1983, he did not learn until September 7 or 15 that Satterlee had been discussing a consulting arrangement with NWB. W-125.

Satterlee's first billing statement to NWB covers the period October 3 through November 14, 1983. Initially, she was paid on an hourly basis plus expenses. S-111. The first payment was $8,744. M-76. The first statement from Satterlee contained expenses dating from September 1, 1983. S-113. Nevertheless, Satterlee testified that during November she still considered her consulting arrangement with NWB to be an "iffy matter." S-117. Her second billing statement to NWB was dated December 7, 1983 and covered the period November 14 to December 5, 1983. M-77.

Madison testified that he authorized payment to Satterlee during this time for "data gathering and polishing of her proposal." M-74.

He said the information was not directly associated with her being a consultant instead it was "to help her support with me reasons why we (NWB) ought to be more receptive to some of the consumer concerns going on." M-73.

On December 2[illegible], 1983, Satterlee billed NWB for the sum of $15,805.99 for the months of October through December, 1983. Madison Depo. Ex. 11. Although not designated as such, both Satterlee and Madison stated that this lump sum was an advance payment for the first quarter of 1984. The payment was made in the last quarter of 1983 for Satterlee's tax purposes. S-118, M-31, M-77. Madison acknowledged it was not necessary to designate that the services were rendered in 1983 in order to be taxed in that year. M-79. This quarterly payment amount was subsequently raised to $25,000 during 1984. M-86.

A formal consulting agreement between Satterlee and NWB was never put into writing. According to NWB attorney Stephen Refsell, whether or not an oral or written contract is used with a consultant depended upon the circumstances. M-82. Madison indicated that at first, when there was not a solid agreement about what Satterlee would do during the fall of 1983, an oral contract was used because the terms were not defined. M-20. By the time they moved to the quarterly payment system, Madison testified he saw no need for a written contract because he was comfortable with Satterlee and knew what she was going to do. M-21, 83. Madison testified that it was not until December, 1983, that the Satterlee consulting and payment arrangements were finalized. M-79.

2. Commissioner Roger Hanson

Roger Hanson was appointed to the Commission in 1979 and served until January 1985. He was reappointed in November 1986 and served until his resignation on January 21, 1986.

Hanson had known Weir since 1968 when Hanson served in the Minnesota legislature and Weir was NWB's liaison there. H-39. Hanson testified that during his time on the Commission, he met more frequently with Weir than any other utility representative because Weir was a long-standing friend. H-44.

Hanson testified that in late October, 1984, he learned he would not be reappointed. H-95. On October 25, 1984, Hanson wrote to the Minnesota Association of Commerce and Industry (MACI)

exploring the possibility of working for it at the expiration of his term. Hanson Depo Ex. 2, H-98-99. Sometime in November, 1984, Weir approached Hanson about consulting for the telephone industry. H-99. Hanson stated that he may have talked with Weir about this idea at the National Association of Regulatory Commissioners (NARUC) convention which was held in Los Angeles from November 25 through 30, 1984. H-104.

Weir testified that sometime before the NARUC convention he proposed to NWB's Chief Executive Officer and Vice President of Minnesota Operations, Gene Bier, that NWB and other telephone companies jointly employ Hanson as a consultant for $45,000 a year on issues that might arise during the upcoming 1985 legislative session. W-155, 159. The legislative issues Weir identified were the proposed change in telephone company taxation from gross receipts to ad valorum taxes, universal service and deregulation. Weir testified he received approval from Bier to proceed with discussions of a joint consulting arrangement for Hanson. W-159. He stated he subsequently raised the idea with Ed Tiemann, executive director of the Minnesota Telephone Association (MTA), at the NARUC Convention. W-161.

Weir stated that Tiemann suggested that the services of Hanson be shared by a separate group of companies working through Robert Johnson, MTA's attorney, rather than through the MTA itself. W-161. Tiemann stated by affidavit that he rejected Weir's proposal to work through the MTA because MTA's employment of Hanson could have an appearance of impropriety. He told Weir to talk to Johnson about the propriety of such an arrangement. He also told Weir that Johnson could act on his own to collect payment for Hanson from other telephone companies without MTA approval. Ex. 57.

According to Weir, he next arranged a meeting for December 7, 1984 with Hanson and Johnson. W-165. Hanson stated he knew before the meeting that Weir wanted to arrange for a number of telephone companies to employ him as a consultant, but that he knew nothing of the details. H-104-105. By the date of the meeting, Weir felt NWB had made a qualified, but not final, commitment to the Hanson consulting arrangement. W-172, 175. At the meeting Johnson agreed to collect the funds from other companies to pay Hanson and he recalls discussing a salary range of $40,000

to $45,000. J-21, 28. Weir is unsure whether he discussed the amount of payment with Hanson on that date. W-171, 195. Hanson stated that he did not recall the dollar amount being established. H-112.

During his deposition, Johnson indicated that his first discussion about this matter was with Ed Tiemann at the end of November, 1984. J-12. According to Johnson, the purpose of the December 7 meeting was to see if Hanson was available for consulting for the telephone industry during the 1985 legislative session. J-14–15. He thought Hanson and Weir had discussed the idea before the meeting. J-23.

Hanson testified that at the close of the meeting he believed Weir's idea was a preliminary suggestion to be pursued. H-109. His understanding was that Weir would be responsible for arranging a group of companies and that Johnson would collect the payments and pay Hanson. In turn, Hanson would be a resource person for Johnson and for the telephone industry as a whole. H-109–113.

Johnson testified that he knew of other situations where one telephone company would collect funds from others to pay a shared expense. J-20. He stated, however, that he had never acted as an intermediary in transferring funds to a consultant before. J-20. Weir testified he knew of other instances where law firms were used to make payments to consultants, but he could not give specific examples. W-169. According to Weir, Dick Bartley, NWB's legislative liaison, had told him "there was a law firm doing retainer work on a consulting basis in the legislative arena." W-170. Bartley was under Weir's supervision until June, 1985 when Weir was assigned to other responsibilities. However, in an affidavit submitted to the Department by NWB on June 17, 1986, Weir contradicted his deposition testimony stating that he is not aware of any other situation in which NWB used a law firm to pay a consultant. Ex. 70.

Hanson testified that on December 31, 1984, MACI informed him they did not have a job for him. On January 7, 1985 Hanson met with Weir and Dick Bartley for preliminary discussions concerning his consulting services. H-121–122. On January 18, Hanson called Weir to inquire if his services were needed. Weir told him that the session was off to a slow start but that he should come down to St. Paul. H-119. Weir believed that NWB had made a final commitment to proceed with the arrangement at that time. W-180.

On January 23, Hanson met with Johnson about the consulting arrangement and he had lunch with Weir on January 24. Hanson stated after these meetings he believed the parties had made a commitment to proceed with the consulting arrangement. H-123. No written contact was ever entered into between any of the parties. H-123.

In January and February of 1985 NWB attempted to involve at least two other telephone companies in funding Hanson's consulting contract. Weir asked United Telephone to participate, but United said it would only do so if the employment was done through the MTA. An inquiry was also made to Garden Valley Telephone Cooperative of Erskine by Weir's assistant, Richard McMillen. Garden Valley decided internally not to go along with the funding but no one from NWB ever followed up on the initial contact. Ex. 17.

Hanson did not have actual work assignments in either legislative or non-legislative areas. H-125. He considered himself available to Johnson or any other representatives of the telephone industry who might need advice or research. H-125-126. The only people he spoke with about his work were Weir, Johnson and Bartley. He had no contact with representatives from other telephone companies. H-126. Hanson stated he found the lack of work frustrating and that he could have been consulted more. H-130. Johnson testified that no one contacted him about utilizing Hanson's services, J-33, although he was certain telephone company representatives contacted Hanson directly. J-32. He said he received "seven, eight, nine" phone calls from Hanson during the legislative session asking what he could do and that Hanson come to the capitol several times during the legislative session. Johnson also noted that the quantity of work had fallen below his expectations. J-35.

Johnson said he thought other people in the telephone industry knew Hanson was on a retainer as a consultant, although Johnson personally did not announce Hanson's availability and could not say specifically how people in the telephone industry might know. Johnson thought Tiemann may have announced that Hanson was working as a consultant at an MTA board meeting. J-32-33. Tiemann stated in his affidavit, however, that he does not recall telling anyone Hanson was available as a consultant. In fact, Tiemann stated he had seen Hanson a number of times at the legisla-

ture and Hanson never told him he was working for NWB or any other company. Ex. 57.

Johnson was aware that NWB was the only telephone company being billed for Hanson's services, but he never felt it was his place to tell Hanson. J-56. Hanson stated that he had a strong suspicion that the other telephone companies had not joined NWB in the consulting arrangement by July, 1985 when Weir's job changed, although Weir never told him directly. H-133.

In July, 1985 Jean Keffeler replaced Weir as NWB's assistant vice president in charge of government relations and regulatory affairs. Weir then became assistant vice president for Minnesota operations and his office moved from St. Paul to Minneapolis. Under a new responsibility code, Weir continued to authorize the payments to Hanson from his new position but out of the regulatory and government relations budget which was under Keffeler's authority. W-190. Keffeler has maintained that she did not know payments were being made to Hanson. Madison Depo. Ex. 2, p. 7. Weir says he never told Keffeler that payments were coming out of her budget. W-191.

Each month either Weir or someone from his office would phone Johnson's office and tell them to bill NWB $3,750 for Johnson's services. J-31. Johnson's office would subsequently bill NWB and receive a check from NWB as a "billed fee." Johnson's office would then issue an office check to Hanson. J-39. NWB records indicate that the consulting payments were coded under the category of attorney and arbitrators fees paid to Johnson, rather than legislative consulting fees paid to Hanson. Weir Depo. Ex. 9 (Code 762 identifies expense), Weir Depo. Ex. 10 (defines Code 762 as used for payments to attorneys and arbitrators). Weir stated the use of the attorney and arbitrator code was a mistake. W-197.

Johnson and Hanson both stated that Hanson performed no services after the end of the legislative session. J-51, H-138. Johnson stated that Hanson was under no obligation to provide post-session services because the agreement was for the session only. J-51. However, Weir said it was not his original intent that Hanson's services would be ended after the close of the legislative session. W-184. Hanson testified the payments were made over the entire year because it was easier for him to budget the payments. H-139. From the original conversations, Hanson believed he would

be kept busy throughout the year or at least be available for consulting during the year. But as time went on it became evident to him that NWB did not have anything for him to do beyond the session. H-140. According to NWB in its February 28, 1986 letter to the Department, Bier, NWB's Minnesota Vice President, thought that had NWB's deregulation legislative activities been as active as originally anticipated in early 1985, Hanson would have been called upon to perform more activities than he did. Madison Depo. Ex. 2, p. 8.

In November, after it was announced that Hanson would be reappointed, Weir and Johnson met to discuss a pro-rata final payment to Hanson. Weir wanted to terminate the payments before Hanson's November 25, 1985 reappointment to the Commission. J-53. The last billing from Johnson to NWB was for $2,750 and remains in Johnson's account. J-53-54. According to Hanson's Log, November 21, 1985, was the last day of his consulting contract with Johnson and Weir. Hanson Depo. Ex. 3.

Hanson did not disclose the consulting arrangement with Weir and Johnson in his application for reappointment to the Commission. He stated he used an old resume and did not consider it important to update it. H-140-141. Moreover, in his initial disclosure filing with the Ethical Practices Board, dated November 11, 1985, Hanson did not list any compensation received or due from either Johnson or NWB. According to Hanson he interpreted the line on the form requsting "Source of Compensation" to refer to future compensation. H-142-144. Although he had designated on the form that the period covered began in October, 1985, he did not disclose the $3,750 payment NWB owed him for October according to the payment arrangement. H-46, Hanson Depo. Ex. 5.

On December 11, 1985, a few weeks after Hanson had rejoined the Commission, the commissioners deliberated the New Ulm Toll Project case (P419/NA-84-334) which had been previously heard by an administrative law judge. The New Ulm Toll Project, a consortium of five small telephone companies in the New Ulm area, sought permission to replace NWB as the long-distance carrier between their respective service territories. NWB and the Department originally opposed the request claiming that NWB should retain the right to be the designated carrier in the area. However, both NWB

and the Department argued later that the Commission's decision in the long distance competition case (P999/CI-85-582) had rendered the issue moot.

The Administrative Law Judge had supported New Ulm, although he found NWB's service to be adequate. The Commission ruled that NWB would continue to be the designated carrier until the matter was resolved in the competition case. The Commission found that New Ulm had not proven that NWB agreed to the removal of its toll facilities and that no company can have its certificate revoked without a finding of inadequate service. It also voted to give the New Ulm companies certificates of convenience and necessity to operate in competition with NWB.

Hanson participated in the deliberations and joined the rest of the commissioners present in voting 4-0 in NWB's favor. In discussions after the motion was made, Hanson made one argument favoring NWB: that the Commission made a formal finding of adequate service. He also made one argument not in favor of NWB; that the approval of NWB as the designated carrier, receiving all 1+ intraLATA traffic, was temporary pending the outcome of the competition case. Commission Tapes Dec. 11, 1985. Ex. 91.

On June 20, 1986, the Commission issued an order rejecting New Ulm's request for a reconsideration of its earlier decision. Ex. 89.

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B. PATTERN OF NWB'S CONTACT WITH COMMISSIONERS

During the course of its investigation into the employment negotiations and consulting arrangements of Hanson and Satterlee, the Department discovered that Weir's expense records showed a consistent pattern of contact through meals between Weir and Commissioners Satterlee, Hanson and Adams. Weir frequently met with these commissioners for meals billed to NWB as "quiet business meals." Madison Depo. Ex. 3, Weir Depo. Ex. 11. In addition to meals, Weir stated that he gave sports tickets to commissioners and

staff and various gifts of flowers and other items reflected in his expense reports. W-85, 123. The Department examined Weir's expense records for the time period of September, 1982 through September, 1983 and April, 1984 through December, 1985. Weir Depo. Ex. [illegible].

Weir's expense records also showed that he met with other commissioners and staff members on occasion.[2] However, other than the three former commissioners, the only other Commission employee Weir claimed more than a few meals with was Richard McMillen. During the time period under investigation, McMillen was the supervisor of the Commission's consumer complaints division. He had previously worked as an analyst on telephone matters for the Commission and had before that supervised the Department's telecommunications section. Weir testified he met with McMillen to discuss complaints and other issues because McMillen had "broad background and knowledge in telecommunications issues." W-95. McMillen left the Commission staff in November, 1984 to work for Weir at NWB. He assisted Weir in regulatory relations until July, 1985 when he was assigned other responsibilities. Weir said he did not discuss pending Commission matters with McMillen. W-91.

Weir acknowledged spending less time with certain commissioners than others. He explained the reason as "It was the way it fell, it's the way I felt it was appropriate, I felt it was appropriate at the time." Weir also said that he may have felt it easier for him to spend time with certain commissioners rather than others. W-97, 98. Weir's expense records show he claimed little or no payment for meals with Commissioners Crump, Hoffman, Kitlinski, Lazenberry, or O'Keefe.

Thomas Madison, Weir's immediate superior until June, 1983, and now NWB's Chief Operating Officer, testified that he reviewed Weir's expense records and was aware that Weir was in frequent contact with commissioners through meals at company expense. M-29. Madison said that such contacts were a way of "developing a communications path." M-40. Weir saw his job as a lobbyist "selling a product, selling a service, selling a company." W-55. He felt his meetings with individual commissioners were social meetings and not generally meant as a vehicle to sell any company policies.

[2]The Department has not attempted to verify the accuracy of Weir's records in regard to persons other than the three former commissioners.

Instead they were "to set up a relationship where they (commissioners) would learn more about the company." W-56.

When asked why he met with the commissioners individually, Weir stated he wanted to "have a relationship with them so that whatever problem they saw in our company or proposal they wanted to make about what we should be doing or how we operate . . . whatever they'd have that they would want to share that they'd feel comfortable saying, Roy, we don't think you're doing a good job, and they did that." W-55. Weir stated he would not discuss general rate case matters with individual commissioners but acknowledged that he would feel free to discuss matters not involved in a rate case. W-57.

Weir had a practice of talking to the commissioners about significant cases before NWB filed the case. W-30–34. Before a general rate case Weir would go to individual commissioners and give them an overall view of the need for a filing and the amount needed. W-33, 34. Weir said it was his personal philosophy that commissioners should know in advance when NWB was going to file a significant request. W-33–34. Hanson recalled that Weir had a practice of generally discussing the company's rate case with him before filing. H-27. This practice of advanced notification is clear in the Basic Six case, a disputed non-rate case matter. NWB filed its petition for prices on March 10, 1983. On March 7, Weir took Adams to lunch; March 8 he dined with Hanson and on March 9 Weir claimed payment for taking Satterlee to lunch. Weir's expense statement shows sale of Basic Six telephones as the reason for all three meals. Madison Depo. Ex. 3.

Weir billed meals to NWB by compiling dates and receipts and giving the information to his secretary. His description of the expense included the person present and a short statement of the purpose of the meal. W-96–82, W-76. He said that there were occasional errors in his reports but that overall he tried to make the expense reports an accurate reflection of expenses he incurred. W-78. According to Weir, the stated purpose of meal was sometimes in error because often there was no real purpose, other than just to maintain a relationship. W-79. Weir also said that when a person's name appeared on the column marked "guest" on his expense report it meant he had paid for that person's meal. W-80.

During their depositions Adams, Hanson and Satterlee were

questioned about the discussions they had with Weir at their meals with him. Questions focused on contacts which occurred when a matter involving NWB was pending before the Commission.

Weir's records indicate that between October 1, 1982 and May 26, 1983 he took Satterlee out for meals approximately three times per month. W-99. Weir's records show that on December 15, 1982, he billed NWB $236.35 for a special birthday dinner for Satterlee and her family. W-100. Weir's records also show he billed NWB for a $45.15 birthday gift on February 28, 1983; a $36.09 gift on May 19, 1983, and an $80.00 gift upon her leaving the Commission. W-102. He said that Satterlee never expressed reservations about accepting these meals or gifts, but that on several occasions she did pay for meals they had together. W-103, 104.

Satterlee testified that in general, she had a policy of paying for her own lunches. In practice, however, Satterlee said sometimes she paid and sometimes she let Weir pay. She stated her policy had nothing to do with Weir being a representative of NWB. S-86. Satterlee disputed the accuracy of Weir's expense records asserting that on serveral occasions she was somewhere else. S-33. Satterlee said both Weir and she each had their personal reasons for the meals. Three items on her personal agenda at these meals were closings of NWB's small-town business offices, intervenor compensation and complaints. S-34.

Specifically, Satterlee had no recollection of a March 9, 1983 meal with Weir and stated that on July 19 her mother died and that she did not have a meal with Weir on that date as his records indicate. S-82, 109. She testified she paid by check for her birthday dinner and she thinks her family members also paid for their own dinners on that date. S-91-92.

Weir's records indicate that he took Adams out for meals approximately four times a month. W-134. During the time period examined, Weir claimed payment for 28 meals including Mrs. Adams and Mrs. Weir. According to Weir, business was not discussed at meals involving spouses, nor was it the main purpose of other meals. W-83. Adams stated that there was nothing inappropriate in accepting meals from regulated company representatives. A-40. Adams stated that the reason he allowed Weir to pay was because Weir invited him. He did not dispute the accuracy of Weir's accounts. A-39-40.

In the spring of 1983, the Commission decided NWB's 82-203 rate case. Commission deliberations occurred on April 4, 5 and 6, 1983 and the final order in the case was issed April 20, 1983. Adams was not present for the vote on April 4, but he did have a meal with Weir in St. Paul that day. In his expense records Weir designated the reason for the meal with Adams as "tariff filings." On April 5, the second day of deliberations, Adams was present for the Commission votes and also had a meal with Weir. Weir stated that he did not discuss with Adams why he did not vote on April 4. W-139, W-141. On his expense report Weir designated the meal's purpose as "Basic Six." Adams had no recollection of what he discussed with Weir at these meals on the days of deliberation. A-51, 53.

Adams had two meals with Weir on April 20, 1983 the day of the final vote of the rate increase. The first, apparently lunch, was designated "tariff filings" while the second, apparently dinner, included both Mrs. Weir and Mrs. Adams. When asked about specific meals with Weir that occurred around times when the Commission was considering contested issues involving NWB, Adams had no recollection of what was discussed. He denied discussing issues before the Commission with Weir. He also said he did not consider that it might appear improper that Weir was taking him out to lunch as often as he did. A-93. Adams testified that he would not have discussed rate case issues with Weir on these dates or others because he did not discuss issues pending in contested cases. A-56. He stated that he did not feel his votes were influenced on any Commission matter by his close association or regular contacts with Wier. A-93.

Between April and December, 1984 Hanson and Weir dined together approximately five times a month. H-47-48. At his deposition Weir stated he could not recall what was discussed at most of these meals. W-208-212. Weir specifically denied discussing with Hanson issues that were before the Commission that spring and summer such as the post-hearing conference in the 83-600 rate case, although he had lunch with Hanson the day of the hearing. Weir and Hanson also dined together on June 6, 1984, the day before Hanson issued a letter to the Commission recommending the 83-600 case not be dismissed as Administrative Law Judge Bruce Campbell recommended, and on June 8 the day the Commission

ordered the judge to issue his report. Weir Depo. Ex. 11, 12, 13. Weir also denied discussing other proceedings pending at the time such as the Centrex/Centron case W-232, or the Yellow Pages issues in the 83-600 case W-232.

Hanson stated that often he, Weir and Adams would have lunches on Friday, before Hanson left for his home in Vergas. All three had known each other from the time when Adams and Hanson were in the legislature. H-45. Hanson stated there were a number of reasons for his frequent contacts with Weir in 1984. Hanson said that Weir was a close friend and he valued his advice. During this time period they discussed topics such as the possibility of Hanson running for the legislature, whether Hanson should seek reappointment to the commission, the death of Weir's father, Hanson's ameliorated rates position paper and attempts by Weir to grow hair on his bald spot. H-48–52. Hanson stated that he understood that any discussion of a contested case would be inappropriate. H-58. He did not dispute the accuracy of Weir's expense records, acknowledging that Weir paid for their meals. He stated that he felt it was a common business practice and there was nothing inappropriate about allowing NWB to pay for the meals. H-56. When asked about contacts with Weir during times when contested cases involving NWB were before the Commission, Hanson denied discussing contested issues, although he could not recall what was discussed on those dates. H-67–83. Hanson also stated that he did not believe Weir attempted to influence his vote. H-84.

From April through the end of August 1984, the Commission dealt with a string of important issues affecting NWB and the entire telephone industry. Chief among them was NWB's requested rate increase, Commission Docket No. P421/GR-83-600 (hereinafter referred to as 83-600). Also, during the 83-600 case, Administrative Law Judge Campbell proposed dismissing the case as a result of NWB's belated disclosure of a corporate restructuring. Other non-rate case issues were toll competition (P442,443,444,421,433/NA-84-212), coin telephone competition (P421/C-82-4645), imposition of access charges (P421/CI-83-203), treatment of Centrex/Centron service (P421/M-83-466, P421/M-84-24,25,26), and treatment of NWB's Yellow Pages revenue (P421/CI-80-518).

During that time period Weir had an unusually high number of lunches and dinners with both Adams and Hanson and commis-

sion staffer Richard McMillen. He had 27 meals with Adams, 8 including Mrs. Adams and Mrs. Weir. Weir had 17 meals with Hanson including two with Hanson's wife and Mrs. Weir. In the month of July, 1984 Weir claimed payment for meals on 16 different days with the two commission members and McMillen. The following month, he claimed he dined on 12 different days with Adams, Hanson and McMillen. W-Ex. 11.

C. INVESTIGATIVE REPORTS

Both NSP and NWB have announced they have hired outside counsel to conduct internal investigations of the circumstances and conduct of their companies in relations with the Commission and the hirings of Hanson, Satterlee and Adams.

In announcing the NWB investigation Keffeler was quoted February 28, 1986 by the *Minneapolis Star and Tribune* as saying the company wished "to remove any shadow on its corporate representation as quickly as possible." According to Keffeler, NWB hired the Wall Street law firm of Hughes, Hubbard and Reed because the firm had experience in assisting corporations in internal examinations. Keffeler also said Hughes, Hubbard and Reed was hired because the firm would assure a high-quality, independent probe. The scope of the law firm's inquiry, according to the newspaper, includes all NWB's policies and practices regarding lobbying and campaign contributions. Ex. 17a.

NSP hired Robert Johnson, former Anoka County attorney, (not the Robert Johnson who served as the intermediary in paying Hanson) to review its conduct with Commission members. On April 9, 1986 the *Minneapolis Star and Tribune* quoted NSP spokesman Peter Vanderpoel as saying Johnson was hired "as a matter of prudency" by NSP's Board of Directors. The newspaper quoted Johnson as saying that NSP's Board told him to do "whatever you have to do" in pursuing his investigation. According to Vanderpoel, Johnson's review is expected to last at least until July 1986. Ex. 48a.

VI. DISCUSSION OF ISSUES AND APPLICABLE LEGAL STANDARDS

The above pattern of facts raises a number of issues of grave

importance to the Commission. Some of these issues concern the legality of past decisions involving commissioners who were negotiating employment with parties appearing before them. Others are important because they affect the public's trust in the Commission's integrity.[3] The following sections discuss the issues raised by the investigation and make recommendations for Commission action on each of the issues.

The issues addressed are: A) Whether NWB's consulting arrangements with Hanson and Satterlee created an appearance of conflict of interest which jeopardized the public's trust in the Commission's adjudicatory role; B) Whether the commissioners' employment negotiations or arrangements should have disqualified them from considering certain issues before the Commission and, if so, what are the appropriate remedies; C) Whether the frequent contacts between NWB and individual commissioners through meals sponsored by NWB violated state law or Commission policy; D) Whether the Commission should promulgate rules regarding ex parte contacts on contested cases and any other formal disputed matter; E) Whether an investigation should be ordered into NWB's control of consulting contracts; and F) Whether NSP and NWB should be ordered to disclose copies of internal investigative reports.

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[3]Even NWB agrees that employment discussions can give the appearance of impropriety. In a letter from NWB dated February 28, 1986, Jean Keffeler, then NWB's Assistant Vice President, states:

> During the last several weeks, however, NWB has become aware that such discussions can give the appearance of impropriety. Therefore, NWB has adopted a policy that precludes discussions of employment or consulting arrangements with any Commissioner while still on the Commission. In addition, NWB's policy in the future will be not to hire a Commissioner unless at least one year has elapsed after the leaving of office. Finally, NWB is willing to participate in the development of appropriate Commission and legislative guidelines which will prevent similar situations in the future by making clear the distinction between acceptable and unacceptable activities. NWB continues to recognize the value of the expertise which former Commissioners can bring to a regulated company and its customers. However, NWB recognizes that it has an obligation to avoid any perception of compromising the public trust. Ex. 17, Ex. 18.

A. Whether NWB's Consulting Arrangement with Hanson and Satterlee Created an Appearance of a Conflict of Interest Which Jeopardized the Public Trust in the Commission's Adjudicatory Role.

The consulting arrangements between NWB and Hanson and Satterlee created an appearance of a conflict of interest which jeopardized the public trust in the Commission's impartiality. Inevitably when soon after leaving the Commission, commissioners go to work for the utilities they once regulated, it raises the suspicion that they did not treat their new employer impartially while on the Commission. Moreover, if, as in the case of Commissioners Satterlee and Hanson, the employment relationship is not fully disclosed, the suspicion of past influence is even more damaging to the public trust.

A number of factors have raised questions about the legitimacy of Hanson's consulting arrangement with NWB. First is the method NWB used to pay Hanson through Johnson. Weir, Hanson and Johnson maintain that payments from NWB were made through Johnson because Weir intended to convince other telephone companies to contribute to Hanson's fund. Weir did, in fact, make an effort to contact at least two other companies. Weir testified that he continued authorizing payments to Johnson for Hanson even after it became apparent that no other companies would participate because he felt he had made a commitment to Hanson. While the participants' explanation of the payment arrangement is credible, the method of paying Hanson through a third party has called into question the legitimacy of the arrangement.

Second, it is apparent from the testimony of the participants that neither Hanson, Johnson nor Weir made much of an effort to tell regulated telephone companies that Hanson was available as a consultant. Johnson claims Hanson's services were mainly advertised through Tiemann. In his affidavit, however, Tiemann states he never announced the availability of Hanson's services to anyone. In fact, no one connected with the consulting agreement told Tiemann who Hanson was working for at the legislature. Indeed, Hanson himself claims not to have known who paid him until after the session ended. Weir did not even tell Jean Keffeler, his successor as assistant vice-president, that Hanson was being paid out of her budget.

This failure to disclose has also fueled speculation about the legitimacy of the Hanson/NWB arrangement.

Third, Johnson and Hanson admitted that Hanson was underutilized as a telephone industry consultant and actually only worked with NWB. This apparent underutilization was accentuated because Hanson's payments were amortized over the entire year even though he only worked during the legislative session. While many consultants are often kept on retainer even when they are not utilized, NWB's payments to Hanson for minimal work immediately following completion of his term as a commissioner was questionable in light of the other circumstances.

Finally, Hanson's failure to disclose his consulting activities at the time he applied for and then later accepted reappointment to the Commission has raised questions about the consulting arrangement. Hanson did not state in either his application to the Governor or in his initial ethical practices statement that he had done consulting work for one or more telephone companies. These omissions, together with the other circumstances described above, has given the impression that the consulting arrangement was intentionally concealed.

The facts surrounding former Commissioner Satterlee's consulting arrangements has also prompted speculation. Unlike Hanson, NWB paid her directly. Like Hanson, however, she began negotiations while a commissioner, did not have a written contract, and her consulting work for the company began soon after her resignation from the Commission. In Hanson's case it was a month, and with Satterlee it was two and one-half months, though she was being paid for expenses a little over a month after leaving the Commission. Her direct dealing with Madison and NWB's initial payments to her to polish her proposal implies that she was given special treatment because she was a former commissioner.

Satterlee also appeared to have been less than direct about her employment arrangements. Both Hanson and Adams, who saw Commissioner Satterlee at the NARUC Convention in November of 1983, testified they were not aware that she was working for NWB at the time. Furthermore, Satterlee initially misrepresented to newspaper reporters the date she started working as a consultant with NWB. As with Hanson, these circumstances have raised questions about the legitimacy of the NWB/Satterlee consulting arrangement.

The Department recognizes Satterlee and Hanson each had qualifications for the jobs they were offered by NWB. Satterlee was hired in large part due to her duly-earned reputation as a consumer advocate both while on the Commission and prior to that. Hanson had operated a small business for years, served in the legislature, and while on the Commission had been, among other things, an advocate for small telephone companies. Both actually took some time in coming to agreements with NWB as to exactly what they would do.

Both Satterlee and Hanson actually engaged in consulting activities on behalf of NWB. Satterlee produced invoices and generally described the work she did for NWB. Hanson kept detailed logs of the trips to St. Paul and the phone calls he made as part of his consulting work. NWB's payments to Satterlee and Hanson were for work either actually done or, as in Hanson's case, anticipated.

Nevertheless, these consulting arrangements created an appearance of a conflict of interest which has jeopardized the public trust in the Commission's impartiality. The above facts demonstrate that that one-year ban on employment of commissioners by regulated utilities which the legislature recently passed and the Governor signed into law, Minn. Stat. § 216B.036(a)(1986), is necessary to assure the public trust in the regulatory process. Similarly, the legislative ban against employing persons on the Commission who worked for a regulated utility in the prior year will further safeguard the integrity of regulatory proceedings. Minn. Stat. § 216B.035(b)(1986).

The principle question, however, for the Department to address in this report is whether the administrative process has been harmed, and if so, identify for administrative remedy those cases which have been affected by the negotiations which took place while the Commissioners were adjudicating cases before them on the Commission. The next section of this report addresses this issue.

B. Whether the Commissioners' Employment Negotiations Should Have Disqualified Them From Considering Issues Before the Commission, and, If So, What Remedies Are Available.

The Department has identified several Commission decisions which require Commission review because of employment negotia-

tions between regulated utilities and Satterlee or Adams. The decisions are: the NWB Basic Six decision (P421/M-83-144 and P421/M-83-167); the NWB Rate Case, 82-203; the Resale of Measured and Full-time WATS service (P421/CI-82-619 and P421/M-83-127); the United Telephone rate case reconsideration (P430/GR-84-597); Peoples Natural Gas docket (G011/PA-85-681); and the Competition Docket (P442, P443, P444, P421, P433/NA-84-212). In addition, the Department has also examined the New Ulm Toll Project case (P419/NA-84-331) to determine whether Hanson's prior employment with NWB affected the Commission's decision in that case. For reasons explained below, the Department does not recommend any actions in the NWB 82-203 rate case or the Peoples Natural Gas case. The Department recommends reconsideration of the Competition Docket, the WATS Resale orders, and the United and New Ulm Toll cases. Dismissal is recommended for Basic Six.

1. Legal Standards

The due process requirement that decision-makers must be impartial applies to those in administrative agencies who act as adjudicators as well as to judges in courts. *Withrow v. Larkin,* 421 U.S. 35 (1975); *Gibson v. Berryhill,* 411 U.S. 564 (1973). The high court has ruled that even an indirect pecuniary interest in a case mandates disqualification of the factfinder. *Ward v. Village of Monroeville,* 409 U.S. 5.7 (1972). Thus, the fairness of decisions made by the Commission while individual commissioners were discussing employment with affected utilities must be questioned.

A recently decided federal case illustrates how seriously employment negotiations can affect the impartiality of a decision-maker. In *Pepsico, Inc. v. McMillen,* 764 F.2d 458 (7th Cir. 1985), the Court of Appeals ordered the district judge to recuse himself because a person acting on behalf of the judge had contacted the law firms of both parties involved in the case to inquire about future employment for the judge. These inquiries were made without the judge's knowledge and both law firms replied that they were not interested in hiring him. The court noted that because one firm had firmly rejected the judge, and the other had not, an objective observer might wonder whether the judge would at some uncon-

scious level favor the firm that had not definitely rejected him. The court stated that a judge could not consider a case in which he has negotiated "albeit preliminary, tentative, indirect, unintentional, and ultimately unsuccessful" with a party in the case over his future employment. The appearance of equal justice, the dignity and independence of the judiciary and the confidence of the public all require recusal in such case. *Id.* at 461.

The Supreme Court has held that most of the law concerning disqualification because of self-interest applies with equal force to administrative adjudicators. *Gibson v. Berryhill, supra,* 411 U.S. at 579. Thus, the same standards should be applied to the Commissioners who were negotiating employment as was applied to the judge in *Pepsico.* Such negotiations jeopardized the ability of the Commission to fairly adjudicate the issues before it and the affected members should have disqualified themselves. As the Commission stated in *In the Matter of the Petition of Northern States Power Co.,* GOO2/GR-85-108 (*NSP*):

> few contacts between a utility and a government official are so egregious as the promise of employment at a time when the official is being asked to rule on matters of consequence to the utility.

NSP at 8.

In the *NSP* case the Commission articulated three possible administrative responses to improper communications with a decision-maker:

> 1. No remedial action is required where the ex parte contacts do not significantly taint the decision or cause procedural unfairness.
> 2. Agency proceedings that have been blemished by ex parte communications are voidable and reconsideration of the decision is the proper remedy.
> 3. Improper ex parte communications which so irrevocably taint the agency's decision-making process may render the agency decision void *ab initio* and the case must be dismissed or judgment rendered against the violating party.

NSP at 6–7.

In determining the appropriate agency response to ex parte communications, the Commission in *NSP* further articulated five considerations to assess whether a particular decision must be voided and the case dismissed. If less than five of these considerations are met, it may be appropriate for the Commission to either take no action or reconsider the tainted decision. These five considerations are:

1. The gravity of the ex parte communications;
2. Whether the contacts may have influenced the agency's ultimate decision;
3. Whether the party making the improper contacts benefited from the agency's ultimate decision;
4. Whether the contents of the communications were unknown to opposing parties, who therefore had no opportunity to respond; and
5. Whether vacation of the agency's decision would serve a useful purpose.

NSP at 7.

The expiration of the reconsideration period does not bar Commission action on past decisions it determines to be tainted. It is well established that administrative agencies have an inherent authority to reconsider their own decisions, since the power to decide the facts in the first instance carries with it the power to reconsider. *E.g. Trujillo v. General Electric Co.*, 621 E2d 1084, 1087 (10th Cir. 1980); *United States v. Sioux Tribe*, 616 F.2d 485, 493 (Cl. Ct. 1980) (and cases cited therein), *Anchor Casualty Co. v. Bongards Coop. Cream Ass'n.*, 253 Minn. 101, 91 N.W. 2d 122, 126, (1958). An administrative agency may reopen a case at any time as long as proper notice is given and the right is exercised within a reasonable time period. *Dawson v. Merit Systems Protection Board*, 712 F.2d 264, 267 (7th Cir. 1983). *Stearns-Hotzfield v. Farmers Ins. Exchange*, 360 N.W. 2d 384, 389 (Minn. App. 1985).

Reopening the Commission decisions at issue here would be within a reasonable time because the Department and the Commission have only recently discovered that these regulated utilities were discussing employment opportunities with sitting commissioners at the time of the decisions. Contentions of bias should be raised as soon as practical after a party has reasonable cause to believe that

grounds for disqualifications exist. *Capitol Transp., Inc. v. United States*, 621 F.2d 1312, 1325 (1st Cir. 1979). Since the Department has only recently uncovered the evidence of bias, its recommendation to reopen the affected dockets is timely.

The Minnesota Supreme Court has stated that an administrative agency should use its power to reopen:

> To serve the ends of essential justice and the policy of the law. . . . [T]he denial to such tribunals of the authority to correct error and injustice and to revise its judgments for good and sufficient cause would run counter to the public interest. . . . [T]he power of correction and revision, the better to serve the statutory policy, is of the very nature of such governmental agencies. *Anchor Casualty Co. v. Bongards Co-op. Cream Ass'n, supra* 91 N.W. 2d at 126.

Thus, the Commission must now reexamine decisions which employment discussions tainted; and, applying the *NSP* criteria, determine the appropriate action.

2. The Commission Decisions Affected by Negotiations

The Department has reviewed the significant decisions of the Commission for the time periods when Commissioners Hanson, Adams and Satterlee were discussing employment prospects with utilities or had been recently employed as a consultant for a company. Ex. 15. Based on this review, the Department identified seven decisions which may have been tainted. In each instance the Department recommends either no futher action, reconsideration, or vacation of an existing order and dismissal.

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C. Whether the Frequent Contacts Between NWB and Individual Commissioners Through Meals Sponsored by NWB Violated State Law or Commission Policy.

It appears a goal of NWB's free meals and regular contacts was to promote a regulatory environment favorable to the company. Weir testified he saw his job as selling the company while Madison

said Weir provided the meals in order to open "communications paths." It is unlikely that a commissioner could be bribed with free lunches or dinners. At the same time, it is only human for a commissioner to positively view a company whose employee she or he dines with on a regular basis at the company's expense.

The former commissioners and Weir testified that there were no improper ex parte contacts during the frequent meals they had at NWB's expense. Moreover, none of the participants felt there was anything inappropriate in NWB's contacts with commissioners at these frequent meals. Weir stated that a thousand dollars worth of meals to a commissioner is not of significant value nor in his opinion did it appear improper. W-257. Although it is unclear whether these sorts of contacts violated state law, these frequent meals, particularly when the Commission was deliberating issues of interest to NWB, have an appearance of impropriety and should be avoided.

Generally, the cost of meals, even meals over long periods of time, could not be said to be a significant portion of a commissioner's income. However during the periods examined the frequent meals provided by NWB to Commissioners Hanson, Satterlee and Adams approach the level of significant portion of their incomes ranging from approximately 1.4% to 4.3% of the commissioners' salaries. According to Weir's records, Hanson received $870 in meals for the 19-month period in 1982, 1983, and 1984 for which the Department has records. Commissioner Adams received approximately $2,700 in meals for the same period as Hanson. Finally, Weir's records reflect that NWB expended approximately $500 in meals and gifts for Satterlee from November, 1982 to July, 1983. Satterlee however disputes some of these expenditures.

The conflict of interest provisions of Minn. Stat. § 216A.035 and 10A.07, for these time periods, do not appear to prohibit these meals. The conflict of interest provision which governed the Commission during these time periods prohibited commissioners from receiving any significant portion of their income "directly or indirectly" from "any public utility." Minn. Stat. § 216A.035. A reading of the legislative history of this statute indicates that the preceding quoted language was enacted as part of the Public Utilities Act of 1974. The reference to "public utility" refers to gas and electric utilities, not telephone companies. *See* Minn. Laws 1974, Chap. 429, Sec. 2. Moreover, the penalty provisions of Minn. Stat. § 216A.035

and enforced against gas and electric utilities under Minn. Stat. §§ 216B.57-216B.61 are lacking under Minn. Stat. Chapter 237. Thus, the prohibition against a commissioner from indirectly receiving income under this section does not encompass telephone companies which are defined and regulated under Chapter 237. This interpretation is substantiated by a recent 1986 amendment to Minn. Stat. § 237. 075 which expands the coverage of this statute to prohibit a commissioner from receiving a significant portion of income directly or indirectly from any public utility "or other organization subject to regulation by the commission." Minn. Laws 1986, Chap. 409, Sec. 3.

Regardless of the language of this statute the Department believes that it was inappropriate and harmed the public trust for these three commissioners to frequently accept meals from NWB even though the law, for the period investigated, did not clearly preclude such activity in the case of a telephone company. The rationale for endorsing a strict conflict of interest standard for gas and electric utilities should apply with equal force and effect to regulated telephone companies.

Second, Minn. Stat. § 10A.07, governing conflicts of interest for all public officials, is not applicable. This statute only applied when those officials make a decision which would "substantially affect" his or her "financial interests." "Financial interests" is defined under Minn. Rules 4515.0100, subp. 5, as: "Any asset owned or controlled by an individual or business which has the potential to produce a monetary return." Meals, even frequent meals, are not assets which have "the potential to produce a monetary return" as required by this rule.

On the other hand, the Code of Ethics for Employees in the Executive Branch, Minn. Stat. § 43A.38, subd. 2, directly prohibits the acceptance of meals by state employees in the executive branch. Executive Branch employees may not accept, in the course of or in relation to their official duties, "any payment of expense, compensation, gift, gratuity, favor, service or promise of future employment or future benefit from any source except the state for any activity related to the duties of the employee unless otherwise provided by law." The acceptance of reimbursement expenses for meals is permissible if approved in advance by the appointing authority, Minn. Stat. 438A.38, Subd. 2(e). The statute directs the appointing

authority to report in writing to the legislative auditor when there is probable cause to believe that a substantial violation has occurred. Minn. Stat. §43A.39, subd. 2.

It is unclear whether Minn. Stat. §§43A.38 and 43A.39 apply to commissioners and other heads of agencies. Although the statute could be read to include agency heads such as commissioners in its definition of employee, the Department of Employee Relations (DOER), which administers these statutory sections, has consistently taken the position that this statute does not cover heads of agencies. DOER's interpretation is based on the distinction drawn between heads of agencies and employees of those agency heads in the definition section of the statute. Minn. Stat. §43A.02. In addition, because the commissioner of employee relations administers this section, DOER considers it unlikely that the legislature intended one commissioner in the cabinet to have reassignment authority over his or her peers. Ex. 75.

Nevertheless, Commission Counsel periodically reminded both the Commissioners and Commission Staff that Minnesota Statutes and Rules prohibited employees from accepting expenses paid without prior approval. In a memorandum dated September 26, 1983, Commission Counsel called the Commissioners' attention to Minn. Stat. 43A.38 and advised them to direct further questions to himself or DOER. Commissioners Adams and Hanson were specifically addressed on the memorandum. Ex. 74.

Regardless of whether the former commissioners' acceptance violated Minn. Stat. § 43A.38, these commissioners were clearly on notice that allowing regulated utilities to pay their expenses was regarded as improper. In 1977, the Governor issued an executive order establishing a code of conduct for officials and employees of the executive branch. Ex. 73. That order prohibited officials from receiving any compensation, reward or gift for greater than $5.00 for any matter related to state government employment. While this order was not in effect for the period covered by the report, commissioners who served at the time it was in effect should have been on notice of the impropriety of accepting frequent meals from utilities.

Memoranda written to Commission Staff on September 3, 1980, Ex. 81; September 25, 1980, Ex. 82; and January 23, 1981, Ex. 83 also reminded the Commission and staff of the impropriety of

accepting meals from regulated utilities. In a memo dated January 23, 1981, the Commission Staff Director notified all staff that the Commission had directed him to establish an agency policy regarding the ethics rules. He ordered the staff not to accept any meals, travel expenses or conference fees from regulated companies. Any exceptions were to be specifically approved on a case by case basis after notification of the Commission.

The memo clearly stated the reasons for such a policy:

> First, it eliminates any real or false impressions of improprieties on the part of the staff. As much damage can be done to the Commission's effectiveness by false impressions of improprieties as actual improprieties. Secondly, a uniform policy will eliminate any uncertainty the staff may have as to what is allowable and what is not allowable. This uncertainty can lead to confusion, misunderstanding, and even dissen(s)ion among the staff. Thirdly, an established policy will give both staff an the regulated utilities a clear line of demarcation. This will eliminate that uncomfortable situation for both staff and the utility when a decision has to be made on a case by case basis by the individual staff person involved.

Commissioners Satterlee, Hanson and Adams were on the Commission in early 1981 when the Commission ethics policy was adopted for the staff. They apparently did not apply the directive to themselves. The Commission policy was specifically directed at staff members and thus covered the conduct of Richard McMillen until he joined NWB in November of 1984. The records maintained by Weir indicate that McMillen did not follow the Commission policy on acceptance of meals during the time he was on the Commission staff.

As a body vested with the execution fo the public trust, commissioners should attempt to avoid even the appearance of impropriety. The Department believes that the pattern of contacts of regular acceptance of meals from one of the companies regulated by the Commission does create an appearance of impropriety. A proper analogy would be discovering that the judge deciding a court case in which you have been involved has lunch paid for by your opponent on a regular basis. Making such a discovery would

inevitably raise the question of whether or not the final decision was fair.

The timing of these meals and important actions by the Commission increases the appearance of impropriety. Weir and the former commissioners stated that they never discussed the merits of contested cases at these meetings and thus no improper ex parte contacts occurred. Even if matters before the Commission were not discussed, however, the frequency of contacts between commissioners and Weir at a time when matters of importance to NWB were being considered increases the appearance of impropriety and further jeopardizes the public trust.

A close examination of the timing of the commissioners' meals with Weir during important decisons on the 83-600 case illustrates this point. On June 2, 1984, Weir took Adams who was then Chairman of the Commission, out for a meal at NWB's expense. On June 5 the Commission heard oral argument on a motion to dismiss NWB's application for a rate increase. The next day Weir again hosted a meal for Adams and Hanson at NWB's expense. The following day, June 7, Hanson wrote a memo to the other commissioners recommending the motion to dismiss NWB's rate request denied. The following day, June 8, Weir, Adams and Hanson again dined at NWB's expense.

The same pattern is found during the time when the Commission was deliberating the merits of the 83-600 case in July, 1984. On July 3, 1984, Weir hosted Adams at a meal. Two days later, July 5, the Commission received a staff briefing on the issues in the NWB's 83-600 rate case. On July 6, while the staff briefing continued, Weir took Adams out for one meal and Hanson out for another meal. On July 9 through 13, the Commission deliberated the 83-600 case. On July 11, Weir, Hanson and Adams went out for a meal at NWB's expense.

Thus, two commissioners had meals paid for by an NWB representative at NWB's expense on the second day of staff briefings about a highly contested rate case and again part way through the Commission deliberations. While the participants state they did not discuss the merits of any contested case, the appearance and timing inevitably raises the questions which the Commission sought to avoid in its 1981 directive to its own staff.

The Department's purpose in undertaking this investigation was

not to recommend action against individual commissioners for arguable violations of the law. Rather, the Department's purpose in reporting the three commissioners' pattern of contact with NWB is to identify areas where improper conduct may jeopardize the commission's adjudicatory role and suggest measures to eliminate such conduct in the the future.

In the code of ethics adopted by the Commission on February 6, 1986, the Commission banned the acceptance of any meals or other gifts from regulated companies. The Department lauds that action. Adoption of the code of conduct makes it clear to both commissioners and to the regulated industries that the Commission seriously seeks to avoid even the appearance of impropriety in the conduct of public affairs.

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III. RECOMMENDATIONS OF THE DEPARTMENT OF PUBLIC SERVICE

The Department believes that employment negotiations such as those with Satterlee and Adams can create an expectation, a hope for future reward, which impairs the objectivity of a neutral decision-maker. Previous employment with such as with Hanson likewise can impair the objectivity of a decision-maker. At a minimum commissioners should disclose potential conflicts to their colleagues and recuse themselves from any disputed decisions involving the companies they have worked for or they hope to work for in the future. The numerous contacts over free meals between NWB and the three commissioners, while perhaps not directly impacting particular decision, could nevertheless help create an environment that is favorable to a regulated company.

To remedy the problems which have come to light in the course of this investigation, the Department makes the following recommendations:

1. The Commission should reconsider its May 4, 1983 decision on resale of WATS services.
2. The Commission should dismiss its decision setting the price of the NWB Basic Six sets (M-83-144) and issue a show cause order to NWB to justify the sale prices charged.

3. The Commission should vacate its order Denying Reconsideration, dismiss the pleadings without prejudice and permit the parties who originally filed petitions for reconsideration to refile such petitions in the United 84-597 rate case.
4. The Commission should reconsider its October 15, 1985 order in the Competition Docket (NA-83-212) to insure that the final order was consistent with the Commission's deliberation votes. The case should be redeliberated if inconsistencies appear.
5. The Commission should vacate its final order and reconsider the New Ulm Toll case (NA-84-334).
6. The Commission should continue in its efforts to adopt formal rules based on its Code of Conduct, outlining the responsibilities of the commissioners and regulated companies as to contacts, particularly during times of deliberation, and the acceptance of meals and other gifts.
7. The Commission should join with the Department in proposing legislation to apply the same penalties to telephone companies who directly or indirectly give a commissioner a significant portion of income as now apply to gas and electric utilities.
8. The Commission should adopt a formal rule setting forth the basis upon which a commissioner should recuse himself or herself from a decision when there may be a conflict of interest.
9. The Commission should order NWB to present a plan for internal audits to assure that its contractual arrangements with consultants are set out in specific detail and that safeguards are used to insure that one type of expense, such as legislative, is not coded as something else, such as legal. Further, the Commission should order an investigation into NWB's contracting procedures and arrangements with law firms and consultants.
10. The Commission should order NWB and NSP to deliver to the Department and the Commission copies of their independent internal investigative reports.

APPENDIX 6

Evan J. HENRY,

Respondent,

v.

MINNESOTA PUBLIC UTILITES COMMISSION,

Petitioner-Appellant.

No. C9-84-1950.

Supreme Court of Minnesota.

Aug. 8, 1986.

Rehearing Denied Sept. 11, 1986.

Northwestern Bell Telephone Company and the Minnesota Public Utilties Commission (MPUC) appeal a decision of the court of appeals reversing an order of the MPUC granting Northwestern Bell a $57 million dollar annual rate increase. The MPUC convened a rehearing and took additional evidence in a rate case brought by Northwestern Bell after the 10-month period for completion of such a case under Minn.Stat. § 237.075, subd. 2 (1984) had elapsed. Evan Henry, an intervenor, appealed the MPUC's final order and adjusted final order in the case, alleging, among other claims, that these orders were based on improper procedure. The court of appeals reversed, holding the MPUC had circumvented the 10-month statutory period and that the rehearing was required to be convened as a contested case proceeding. We reverse the decision of the court of appeals on these issues and otherwise affirm. We reinstate the final order and adjusted final order of the MPUC.

The factual background of this case is complex. Northwestern Bell filed a petition with the MPUC on September 19, 1983 seeking a $109 million dollar annual rate increase and a modification of its rate structure. The MPUC suspended the proposed rate schedule and initiated a contested case proceeding. A lengthy series of hearings on the petition were held before an ALJ at locations throughout the state in January-April 1984.

While these hearings were in progress, Northwestern Bell was

planning an extensive corporate reorganization. In January 1984, the company filed a corporate restructuring plan with the Federal Communications Commission. Copies of these filings were presented to the MPUC on April 26, 1984, at which time Northwestern Bell notified the commission that, as of April 30, 1984, it would incorporate a new holding company. The holding company would have as its wholly-owned subsidiary a telephone services operating company, Northwestern Bell Telephone Company, who became the petitioner in the pending rate case.

The timing of the company's notice of restructuring limited the ability of the ALJ and the MPUC to respond to the new information within the context of the pending rate case. Hearings on the petition had already been completed and the MPUC was required to issue its final determination by July 30, 1984 to meet the time limit imposed by Minn.Stat. § 237.075, subd. 2 (1984). Subdivision 2 establishes a 10-month period during which a utility's proposed rates may be suspended following a petition for rate change. If the MPUC does not make a final determination concerning a schedule of rates within 10 months after the petition is filed, the rate schedule proposed by the utility is deemed approved. *Id.*

The ALJ called a post-hearing conference of all parties on May 14, 1984, to determine if the present record in the case adequately reflected the financial effect of the corporate reorganization. Following the conference, motions to dismiss Northwestern Bell's petition were filed with the ALJ by several intervenor parties, including Evan Henry, the respondent before this court, and the Department of Public Service (DPS). The MPUC, for its part, responded to the notice of reorganization by ordering the DPS to investigate the financial effect of the corporate restructuring on the pending rate petition.[1] Subsequently, Northwestern Bell entered into a stipulation with the DPS, agreeing that the effect of the reorganization should be considered in the evidentiary record of the rate proceeding and agreeing not to contest the DPS' recommendations to the MPUC as to the amount of any rate adjustment needed to account for the

[1] Minn.Stat. § 237.081, subd. 1 (1984) provides the MPUC may, on its own motion, summarily investigate any matter relating to any service it believes "for any reason" should be examined. If, after making such summary investigation, the MPUC is satisfied there are sufficient grounds to warrant a formal hearing on the matters investigated, it may initiate such a hearing. Minn.Stat. § 237.081, subd. 2 (1984).

the financial effect of the corporate reorganization. The DPS thereafter withdrew its motion to dismiss.

Before the DPS investigation was concluded and its report submitted, however, the ALJ recommended to the MPUC that the rate petition be dismissed. In the considered opinion of the ALJ, the financial effect of the corporate reorganization was likely to be substantial and had to be considered before any decision on the rate petition could be made. The ALJ stated he did not have sufficient time to hold hearings on the reorganization before the 10-month statutory period expired. He concluded that Northwestern Bell, by failing to introduce sufficient evidence into the present record on which a final determination could be reached, had not met is statutory burden of proof and he recommended the rate petition be dismissed on this ground.

The MPUC, on receiving this recommendation, informed the ALJ that it had decided to address the restructuring issue within the context of the pending proceeding. The commissison stated it would render a decision on the present record within the 10-month period and then, on its own motion, reopen the proceeding for hearings on the restructuring issue. The ALJ was asked to submit recommendations on the substantive issues in the rate case, excluding consideration of the effect of the corporate restructing. The ALJ thereafter submitted a second report, recommending that Northwestern Bell be awarded $57,511,000 in increased annual revenues and that a new rate structure be imposed. Based on these recommendations, the MPUC issued a final determination in the rate case on July 27, 1984, authorizing the recommended rate increase and adopting the recommended rate structure. The July 27, 1984 final order was issued within the required 10-month period.

The DPS submitted its report to the MPUC on the financial effect of the corporate restructuring on August 1, 1984, recommending a downward adjustment of $371,000 to the rate increase previously ordered. Shortly thereafter, this figure was revised to $363,000. The MPUC, on its own motion, ordered a rehearing and a reopening of the record for the purpose of receiving into evidence the DPS report and to determine if a further evidentiary hearing and separate contested case proceeding regarding the financial effect of the corporate restructuring were required. At the rehearing, no party objected to the amount of the DPS' proposed adjustment.

Evan Henry objected to the rehearing procedure, alleging the MPUC did not have authority to reopen the proceeding after it had issued a final determination. He renewed his motion to dismiss the petition and the MPUC denied the motion. An adjusted final order incorporting the downward adjustment was issued by the MPUC on September 26, 1984, almost 12 months after the rate petition had been filed. This appeal followed and Henry prevailed before the court of appeals.

The MPUC and Northwestern Bell raise four issues before this court:

1. Did the MPUC act within its statutory authority under Minn. Stat. §237.075, subd. 2 (1984) in ordering a rehearing after reaching a final determination?

2. Was the MPUC required by either Minn.Stat. § 237.075, subd. 2 (1984) or Minn.Rules pt. 1400.8300 (1985) to consider the issue of Northwestern Bell's corporate reorganization in a contested case procedure and did the summary procedure adopted for the rehearing in this case violate Henry's constitutional right to due process?

3. Did the composition of the MPUC who heard this case satisfy the requirements of Minn.Stat. § 216A.03 (1984)?

4. Did Northwestern Bell meet its burden of proof under Minn. Stat. § 237.075, subd. 4 (1984) as to the rate increase awarded?

I.

The MPUC and Northwestern Bell seek reinstatement of the July 27, 1984 final order and the September 26, 1984 adjusted final order of the MPUC. The court of appeals reversed the orders as based on improper procedure in that the MPUC did not have statutory authority to order a rehearing after reaching a final determination in a rate case. An agency determination based upon unlawful procedure or affected by an error of law will be overturned if the substantial rights of the person challenging that determination have been thereby prejudiced. Minn.Stat. § 14.69 (1984).

Minn.Stat. § 237.075, subd. 2 (1984) provides that after a petition for a rate change has been filed, the MPUC may, while considering the petition, suspend the proposed rates, but not for a longer period than 10 months. If the commission does not make a final determination concerning a schedule of rates within 10 months

after the initial filing date, the utility's proposed schedule is "deemed to have been approved." *Id.* Subdivision 2 further provides, however, that the MPUC may convene a rehearing and that this rehearing will, in effect, toll the 10-month time limit:

> For the purposes of this section, 'final determination' means the initial decision of the commission and not any order which my be entered by the commission in response to a petition for rehearing or other futher relief. The commission may further suspend rates until it determines all those petitions.

Id. No one disputes in this appeal that the quoted language of subdivision 2 gives the MPUC the power to order a rehearing or provide further relief after it has reached a final determination. The heart of the parties' dispute concerns the circumstances under which it is proper for the MPUC to use its rehearing power.

The MPUC, while recognizing that the effect of the corporate reorganization had to be considered as part of any decision on the rate petition, issued a final determination in the case within the 10-month period based on a record that did not consider the issue. The commission then convened a rehearing on its own motion to receive evidence on this issue into the record and issued an adjusted final determination based on this augmented record. The court of appeals concluded this use of the MPUC's rehearing power was improper as an effort to "circumvent the 10-month statutory limitation." This effort, the court of appeals stated, "must fail as a sham." *Henry v. Public Utilities Commission,* 376 N.W.2d 226, 231 (Minn. Ct.App.1985). Further, the court of appeals reasoned, this use of the rehearing power was improper because it "ignore[d] the role of a rehearing in an administrative procedure," which is to serve the purpose of error-correction. *Id.*

We reject, first of all, this interpretation of the legal effect of subdivision 2's provision for a 10-month rate suspension period. The statutory time limit refers only to the period during which rates may be suspended and is not a temporal limit on the MPUC's jurisdiction, as the court of appeals seemed to conclude. The clear purpose of the provision is to protect utilities from the potentially confiscatory effect of regulatory delay. In other cases where we have

interpreted similar statutory time limits, we have construed these provisions as directory and not mandatory, stating the time limit "define[s] the time and mode in which public officers shall discharge their duties, and ****** [is] obviously designed merely to secure order, uniformity, system, and dispatch in the public business." *Heller v. Wolner*, 269 N.W.2d 31, 33 (Minn.1978) (citation omitted). Consistent with these cases, we conclude subdivision 2 does not deprive the MPUC of jurisdiction to issue a decision in a rate proceeding if it fails to reach a decision within the 10-month suspension period.

We are also not persuaded that by convening the rehearing on its own motion in this case, the MPUC abused the poper purpose of a rehearing in administrative procedure. The statutes that govern the MPUC's proceedings give the commission authority "to hold hearings and make determinations upon its own motion to the same extent, and in every instance, in which it may do so upon petition." Minn. Stat. § 216A.05, subd. 5, (1984). This rate case proceeding, one of the largest and most complex in the MPUC's history, had required a great deal of time, money and effort from many parties. The commission estimated that the alternative to the rehearing procedure it adopted, dismissal of the rate case, would have resulted in costs of two to three million dollars, costs which were likely to be borne by Northwestern Bell's rate payers. The proceeding had produced a substantial record on a whole range of issues, many of which were not affected by the corporate reorganization. We therefore conclude the MPUC's decision to order a rehearing after a final determination is this case was lawful, practical, and served the public interest.

We hold the MPUC acted in this case within its statutory authority under Minn.Stat. § 237.075, subd. 2 (1984) in ordering a rehearing after reaching a final determination. The decision of the court of appeals to the contrary is reversed.

II.

The court of appeals also based its decision on the ground that the MPUC was required by subdivision 2 and Minn.Rules pt. 1400.8300 (1985) to consider the issue of Northwestern Bell's corporate reorganization in a contested case proceeding rather than the summary rehearing procedure it adopted. *Henry*, 376 N.W.2d at

231-32. Henry also claims the rehearing was improper because its summary nature deprived him of constitutional due process.

An agency must initiate a contested case hearing when one is required by law. Minn.Stat. § 14.57 (1984). Subdivision 2 requires a contested case hearing when the MPUC determines that a "significant issue" of the reasonableness of the rates requested by a utility cannot be resolved to the satisfaction of the commission. Minn. Stat. § 237.075, subd. 2 (1984).

The MPUC convened a rehearing in this case for the purpose of receiving into evidence the DPS report on the financial effect of Northwestern Bell's corporate reorganization on the ordered rate increase for determining whether there was cause to hold further evidentiary hearings in the form of a contested case proceeding on the matter. Before the hearing, a copy of the DPS report was served on all parties, including Henry, and comments were invited. At the hearing, which Henry attended, the MPUC again solicited testimony or comment on either the report or the restructuring issue. Henry did not object to the report either before or at the hearing, nor did he request a contested case hearing at either of these times. In his brief to this court, Henry claims he approached an [sic] MPUC commissioner immediately after the rehearing was adjourned and asked for an opporuntity to question the DPS on its report. He renewed this request in a letter four days later. By order dated September 26, 1984, the MPUC adjusted the rate increase downward and ruled that further hearings were not required on the issue of reorganization.

We infer from its action that the MPUC concluded the issue of reorganization was not an unresolved issue and we find this a reasonable conclusion. The DPS had reported that the financial effect of the reorganization could be accounted for by a minor downward adjustment in the rate increase ordered, an adjustment to which Northwestern Bell had previously stipulated. All parties to the rate proceeding were given ample notice and opportunity to challenge this proposed resolution of the issue and none did, including Henry. Given this apparent consensus, the MPUC could conclude there was no dispute over the matter. Thus, under the standards of subdivision 2, there was no "unresolved" issue requiring a contested case hearing.

Nor does Minn.Rule pt. 1400.8300 (1985) require a contested case

procedure in this case. The rule provides that a rehearing shall be conducted "in the same manner prescribed for a hearing." *Id.* This means that the standards contained in subdivision 2 for ordering a contested case proceeding should be applied whether the proceeding at issue is an original proceeding or a rehearing. We have already concluded the statute did not require this rehearing to be convened as a contested case proceeding.

Finally, we do not agree that the summary procedure the MPUC adopted for the rehearing deprived Henry of due process as guaranteed by our state and federal constitutions. He, like all other parties, received fair notice and opportunity to make his views known. He was given notice and several opportunities to question the DPS report or to request further evidentiary hearings on the matter and he did not avail himself of these chances. Inexplicably, he attempted to participate in any hearings on the matter and to question the DPS only *after* the hearing had been adjourned. This request was not a timely or reasonable effort to participate and the MPUC's failure to respond to the request did not violate fundamental fairness or due process. We hold the MPUC was not required by Minn.Stat. § 237.075, subd. 2 (1984) or Minn.Rules pt. 1400.8300 (1985) to consider the issue of Northwestern Bell's corporate reorganization in a contested case proceeding. We further hold the summary procedure adopted for the rehearing in this case did not deprive Henry of constitutional due process.

III.

Henry claimed before the court of appeals that the MPUC members who decided this case lacked the qualifications required by Minn.Stat. § 216A.03 (1984). This challenge was rejected on the ground that a court is not the appropriate forum in which to consider the qualifications of commissioners under the statute. We agree. Section 216A.03 directs that members of the MPUC shall be appointed by the governor with the advice and consent of the senate. In selecting members, the governor is directed to give consideration to "persons learned in the law or persons who have engaged in the profession of engineering, public accounting or property and utility valuation as well as being representative of the general public." *Id.* In enacting this statute, the legislature has suggested that the governor "consider" persons with certain professional expertise when appointing members, but the governor's authority if

not constrained by the law and no legal duty regarding the qualifications of those appointed is thereby created that we can enforce. We affirm the decision of the court of appeals on this issue and we hold this court is not an appropriate forum in which to challenge the qualifications under Minn.Stat. § 216A.03 (1984) of the MPUC commissioners who heard this case.

IV.

Henry's final claim is that Northwestern Bell did not meet its statutory burden of proof as to the rate increase ordered. Telephone service rates are to be fair and reasonable. Minn.Stat. § 237.06 (1984). A telephone company petitioning for a rate change bears the burden of proving the rate change it proposes is "just and reasonable." Minn.Stat. § 237.075, subd. 4 (1984). If, after hearings, the MPUC finds the proposed rates are unjust, unreasonable or discriminatory, the commission shall determine the rates to be charged. Minn.Stat. § 237.075, subd. 5 (1984).

We will review the MPUC's determination of a just and reasonable rate in this case according to the substantial evidence standard for rate of return determinations and the arbitrary and capricious standard for rate design determinations. *Hibbing Taconite Co. v. Public Service Commission,* 302 N.W.2d 5, 9 (Minn.1980). Based on our careful review of the evidence in the record of this case and the 100-page order of the MPUC, we conclude the decision of the MPUC was supported by evidence in the record and was not arbitrary and capricious. We therefore hold Northwestern Bell met its statutory burden of proof under Minn.Stat. § 237.075, subd. 4 (1984) as to the rate increase ordered.

Revered in part; affirmed in part. The July 27, 1984 and September 26, 1984 orders of the MPUC are reinstated.

APPENDIX 7

OFFICE - NOVEMBER 7, 1986

The Commission met on November 7, 1986 with Chair Crump and Commissioners Beerhalter, Kitlinski, O'Keefe and Peterson present.

The following items were adopted by the Commission.

U-999/CI-86-177
Investigation of the Nature and Extent of Contacts between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners

Commissioner O'Keefe moved to reject the petitions to reopen the following four dockets: *Instrastate Intercity Telecommunications Services (Toll Competition),* Dockets No. P-442 et al/NA-84-212; *United Telephone Company,* Docket No. P-430/GR-84-597; *Northwestern Bell Telephone Company,* Docket Nos. P-421/CI-82-619, P-421/M-83-127 and P-421/M-80-306 (WATS Resale), and *Northwestern Bell Telephone Company,* Docket Nos. P-421/M-83-144, P-421/M-83-167, P-421/M-82-473, P-421/M-82-476, P-421/M-4-82-277 (Basic Six) and to affirm its decision not to reopen *New Ulm Telecom,* Docket No. P-419/NA-84-334.

The motion passed 4-0. Commissioner Kitlinski not present.

Commissioner O'Keefe moved to reject the motion of the Minnesota Public Interest Research Group (MPIRG) to dismiss the *Northwestern Bell Telephone Company,* Docket No. P-421/GR-83-600 (NWB 83-600) Findings of Fact, Conclusions of Law, and Order of July 27, 1984.

The motion passed 4-0. Commissioner Kitlinski not present.

Commissioner Crump moved to deny MPIRG's motion to reconsider the November 13, 1984 Order Denying Intervenor Compensation in *NWB 83-600.*

The motion passed 5-0.

Commissioner O'Keefe moved that it is reasonable to assume

that Northwestern Bell ratepayers have difficulty believing that their rates were arrived at in a fair and proper manner when two members of the commission that established the rates were wined and dined extensiveley by Northwestern Bell during the time that the rates were under consideration. A public perception of unfairness is certainly understandable and should be corrected. The lunches and dinner gave a NWB representative greater access to the two Commissioners in friendly surroundings than was enjoyed by other participants in the case and represented a serious abuse of the system.

The motion passed 5-0.

Commissioner O'Keefe moved to reconsider and redeliberate *NWB 83-600* and that to assure that current practices have been or are being updated to conform with the Commission's new Code of Conduct and Ex Parte rules, NWB shall file with the Commission a company code of conduct and updated expense reimbursement policy for contacts with the Commission and staff.

The motion passes 5-0.

There being no further business, the meeting was adjourned.

APPROVED BY THE COMMISSION
Harry Seymour Crump, Chair
Barbara Beerhalther, Commissioner
Cynthia A. Kitlinski, Commissioner
Robert J. O'Keefe, Commissioner
Darrel L. Peterson, Commissioner

APPENDIX 8

BEFORE THE MINNESOTA PUBLIC UTILITES COMMISSION

Barbara Beerhalter	Chair
Harry Seymour Crump	Commissioner
Cynthia A. Kitlinski	Commissioner
Robert J. O'Keefe	Commissioner
Darrel L. Peterson	Commissioner

ISSUE DATE: April 02, 1987

DOCKET No. U-999/CI-86-177

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners

Order After Investigation and Vacating July 27, 1984 Order in Docket No. P-421/GR-83-600
In the Matter of the Application of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota

***

On April 9, 1986, the Minnesota Public Utilities Commission (the Commission) issued its order Initiating Investigation in this docket. In that Order, the Commission directed the Minnesota Department of Public Service (DPS) to conduct an independent investigation to assess whether any improper communications occurred during Commission proceedings addressing issues of significant financial impact to regulated companies or addressing significant policy issues likely to lead to a significant financial impact on regulated companies.

The Commisssion directed that the investiagtion cover at least the last several months of the Commission terms of former Commissioners Juanita R. Satterlee, Roger L. Hanson, and Leo G. Adams. The Commission could then use this investigation to remedy any improper influence caused by these contacts.

On July 8, 1986, the DPS submitted its "Report of the Department of Public Service to the Minnesota Public Utilities Commission" (the DPS Report). The DPS also submitted the depositions and documents that it obtained in the course of its investigation as supporting exhibits to the DPS Report. The DPS identified seven decisions which may have been improperly influenced by employment discussions between regulated companies and then-sitting Commissioners and recommended that the Commission reopen the following five decisions: *Intrastate Intercity Telecommunications Services,* Docket No. P-442 et al/NA- 84-212 (October 15, 1985) (*Toll Competition*); *United Telephone Company,* Docket No. P-430/GR-84-597 (August 12, 1985) (*United*); *New Ulm Telecom,* Docket No. P-419/NA-84-334 (March 14, 1986) (*New Ulm*); *Northwestern Bell Telephone Company,* Docket Nos. P-421/C1-82-619, P-421/M-83-127, and P-421/M-82-512 (May 16, 1983) (*WATS Resale* docket); *Northwestern Bell Telephone Company,* Docket Nos. P-421/M-83-144, P-421/M-83-167, (June 1, 1983) (*Basic Six*). The DPS stated that no corrective action was necessary in *Northwestern Bell Telephone Company*, Docket No. P-421/GR-82-203 (April 20, 1983) or *In the Matter of the Acquisition of Peoples Natural Gas Company by Utilicorp United, Inc.*, Docket No. G-011/PA-85-681 (December 4, 1985). The DPS also made five other recommendations which related to actions to eliminate future improper contacts.

On August 13, 1986, Northwestern Bell Telephone Company (NWB) filed a response to the DPS Report, asking the Commission to deny the DPS recommendations to reopen the *WATS Resale, Basic Six, New Ulm,* and *Toll Competition* decisions.

On July 9, 1986, the Residential Utilities Division of the Office of the Attorney General (RUD-AG) filed a petition requesting the Commission to reopen and reconsider its July 27, 1984, Findings of Fact, Conclusions of Law, and Order in *Northwestern Bell Telephone Company,* Docket No. P-421/GR-83-600 *(NWB 83-600).* The petition claimed that this proceeding had been improperly in-

fluenced by ex parte communications between NWB and former Commissioners during deliberations on the case. The DPS Report had revealed these communications. On July 18, 1986, NWB filed its response asking the Commission to deny the RUD-AG petition. On August 1, 1986, the RUD-AG filed a reply brief to NWB's response. On September 15, 1986, NWB responded to the RUD-AG reply brief.

[sic] filed a petition requesting that the Commission vacate and dismiss its Juy 27, 1984 and November 13, 1984 Orders in *NWB 83-600* for reasons similar to those given by RUD-AG. On September 15, 1986, NWB responded to MPIRG's petition, asking that the petition be denied.

On October 3, 1986, the Commission isued[sic] its Order Establishing Procedures and Soliciting Briefs in this matter. That Order requested parties to submit briefs on whether *NWB 83-600, Toll Competition, United, New Ulm, WATS Resale, Basic Six* or any other decisions in the relevant time period were improperly influenced due to a conflict of interest or ex parte communications between former Commissioners Adams, Hanson or Satterlee and regualted companies. The Order requested that parties address the following questions in their briefs:

1. Were any of the decisions identified above affected by conflicts of interest or ex parte contacts?
2. Did any party seek to influence Commissioners or gain advantage in a case by employment discussions or other contacts with Commissioners?
3. Did any party successfully influence Commissioners' decisions by their contacts?
4. If any of the decisions were tainted by conflicts of interests or ex part contacts, what is the appropriate remedy in each instance?
5. Is the evidence contained in the DPS Report, depositions and exhibits sufficient for the Commission to resolve the questions posed above? If not, identify specific evidence challenged or to be introduced that a party believes is necessary for the Commission to resolve the questions.

The October 3, 1986 Order also required Northern States Power Company (NSP) and NWB to submit copies of their internal investigation reports to the Commission. On October 13, 1986 NSP filed

its internal investigation report.

On October 23, 1986, United Telephone Company (United), the Suburban Rate Authority (SRA), MPIRG, RUD-AG, NWB, and the DPS filed comments or briefs. In its brief, the DPS recommended that the Commission redeliberate *NWB 83-600* on the merits. The DPS had not recommended reopening this case in its July 8, 1986 Report which focused on the impact of job negotiations, rather than on gratuities and ex parte contacts. On October 24, 1986, the Minnesota Business Utility Users Council (MBUUC) filed a letter addressing this matter and U.S. Sprint filed a brief.

On October 28, 1986 the Commission issued its Notice of Oral Argument.

On November 3, 1986, NWB filed its Reply to the submissions of the other parties.

Oral argument was held on November 6, 1986, with representatives of the DPS, the RUD-AG, MPIRG, the SRA, the MBUUC, AT&T, and NWB participating.

SUMMARY OF ISSUES

I. Does the Commission have jurisdiction and legal authority to reopen prior rate proceedings?
II. Should the *NWB 83-600* docket be reopened?
III. Should the *Toll Competition* docket be reopened?
IV. Should the *United* docket be reopened?
V.. Should the *WATS Resale* docket be reopened?
VI. Should the *Basic Six* docket be reopened?
VII. Should the *New Ulm* docket be reopened?

FINDINGS AND CONCLUSIONS

I. The Commission's Authority to Act

The first issue the Commission must address in this proceeding is whether it has jurisdiction over these matters to correct any abuses that may have occurred due to a conflict on interest or ex parte comunications.

The Commission is aware that all of the matters addressed in this proceeding involve Orders that were issued at least a year or more ago. The Commission is also aware that the courts have expressed a strong disinclination to reopening orders and judgments after a reasonable time. Minnesota courts have held that a state agency has jurisdiction to reopen its orders to correct *erroneous*

adjudications, mistakes of fact or fraud (within or between parties) until jurisdiction is lost by appeal or laspe of time. *State by Turnbladh v. District Court,* 259 Minn. 228, 107 N.W.2d 307 (1960); *Anchor Gas. Co. v. Bongard's Coop. Creamery Ass'n.* 253 Minn. 101,91 N.W.2d 122 (1958). In addition, a one year time limit is placed on the authority of Minnesota courts to reopen their judgments and orders to correct an *erroneous* decision that resulted from mistakes, inadvertance, excusable neglect, newly discovered evidence, or fraud (within and between parties). Minnesota Rules of Civil Procedure, Rule 60.02.

The Commission further recognized that the time limitations imposed on agencies and courts for reopeing their judgments and orders apply to circumstances in which the impetus for reopening is a claim that the judgment or order is *erroneous.* Here the Commission is concerned not with erroneous adjudications but with the integrity of the decision making process itself, and the public's perception of the process.

The real question presented in the matters now under review is whether the ex parte contacts or the conflicts of interest constitute egregious conduct that attacks or undermines an integral aspect of the adjudicatory process or the impartiality of a decison maker. Such conduct is often referred to as "fraud upon the Court" or in this case, "fraud upon the Commission." Courts and administrative agencies have the inherent power with no time limitations to vacate a judgment or decision that has been obtained under such circumstances. *Halloran v. Blue and White Liberty Cab Company,* 253 Minn. 436, 92 N.W.2d 794 (1958); *Universal Oil Products Co. v. Root Refining Co.,* 238 U.S. 575 (1946); *Hazel-Atlas Galss Co. v. Hartford-Empire Co.,* 322 U.S. 238 (1944); *State ex. rel. Corbin v. Arizona Corporation Commission,* 143 Ariz. 219, 693 P.2d 363 (1984); *WKAT, Inc. v. Federal Communications Commission,* 296 F.2d 375 (D.C. Cir. 1961). The Commission concludes that it has the inherent power to remedy matters where it finds that a basic assault and abuse on the regulatory process itself has been committed. Because the Commission has authority to supervise its own processes it can replace the improper process, when it finds such has occurred, with a valid one. Whether such abuse of the process has occurred is a question that must be answered by examining the facts surrounding the ex parte contacts or conflicts of interest.

Some federal courts have attempted to define fraud upon the court as conduct which defies the court itself or in which court officers conduct themselves in a way as to impair judicial machinery and prevent an impartial adjudication. *Serzysko v. Chase Manhattan Bank*, 461 F2d 699 (2d Cir. 1972), *cert. denied* 49 U.S. 883 (1972). Other courts have defined this type of fraud as an unconscionable plan or scheme to improperly influence the court in its decision. *England v. Doyle*, 281 F.2d 304 (9th cir. 1960). The definition that is most often repeated in cases on the issue is that suggested by Professor Moore:

> "Fraud upon the court" should, we believe, embrace only that species of fraud which does or attempts to, subvert the integrity of the court itself, or is a fraud perpetrated by officers of the court so that the judicial machinery cannot perform in the usual manner its impartial task of adjudicating cases that are presented for adjudication... ."
>
> 7 *Moore's Federal Practice*, 60-360.

The Commission agrees that these definitions should be used here to judge whether the cases have been so tainted as to require further action.

The central theme of an inquiry into whether a court's, or an agency's, process has been so abused as to constitute fraud upon the court, or the agency, is to determine if the decision is not a product of fair, unbiased, and impartial judgment, but rather is due to influence caused by improper contacts made to a decision maker. A decision that should be reached impartially but rather is in fact the consequence of improper influences from outside the lawful decision making process should not stand. The object of the Commission's inquiry is to determine whether its decisions were reached by fair and impartial processes or by processes tainted by improper contacts or conflicts of interest.

In order to evaluate whether and to what extent fair processes have been abused in the matters under review, the Commission has considered the following criteria:

1. The gravity of the ex parte communications;

2. Whether the contacts may have influenced the agency's ultimate decision;
3. Whether the party making the improper contacts benefited from the agency's ultimate decision;
4. Whether the contents of the communications were unknown to opposing parties, who therefore had no opportunity to respond; and
5. Whether vacation of the agency's decision would serve a useful purpose.

These criteria were used by the Commission in *Northern States Power Co.*, Docket No. G-002/GR-85-108, Order Vacating December 30, 1985 Order (February 19, 1986), slip op. t 7, citing *Professional Air Traffic Controllers Organization v. Federal Labor Relations Authority*, 685 F2d 547 (D.C. Cir. 1982).

Case law recognized at least three possible administrative responses to improper communications with a decision maker. First, the Commission can decide that no remedial action is required where the ex parte contacts do not significantly taint the decision or cause procedural unfairness. *Professional Air Traffic Controllers Organization v. Federal Labor Relations Authority*, 685 F2d 547 (D.C. Cir. 1982). Second, agency proceedings that have been blemished by ex part communications have been held to be voidable and reconsideration of the decision has been held to be the proper remedy. See, *Massachusetts Bay Telecasters v. FCC*, 295 F.2d 131 (D.C. Cir. 1962). Third, improper ex parte communications may render an agency decision void *ab initio*, and the case must be dismissed or judgment rendered against the violating party. See, *Hazel-Atlas Company v. Hartford Company*, 322 U.S. 238 (1944); *WKAT, Inc. v. FCC*, 296 F.2d 375 (D.C. Cir. 1961).

The Commission will use the five criteria listed above to analyze the matters under review to determine whether and how to exercise its authority to correct abuses to the regulatory process resulting from fraud on the Commission.

II. Should *NWB 83-600* Be Reopened?

Docket No. P-421/GR-83-600

Description of Contacts

The RUD-AG recommended that the Commission reconsider and redeliberate its July 27, 1984 Findings of Fact, Conclusions of Law and Order in *Northwestern Bell Telephone Company*, Docket

No. P-421/GR-83-600. The SRA supported the RUD-AG recommendation. The DPS also recommended redeliberation. MPIRG recommended that the Commission dismiss *NWB 83-600* and reconsider its November 13, 1984 Order Denying Intervenor Compensation.

The MBUUC states that reconsideration or dismissal of *NWB 83-600* may not serve the public interest, causing more disruption and harm than benefit. NWB recommended that the Commission dismiss the RUD-AG petition for reconsideration and the MIRG [sic] petition to dismiss *NWB 83-600*.

Based on the record, including the DPS report and exhibits and the pleadings of the parties, the Commission makes the following findings of fact:

In August, 1983 NWB announced its intention to file a rate increase with the Commission. It did so on September 29, 1983 requesting a $109 million increase in rates. The Commission issued its Findings of Fact, Conclusions of Law and Order on July 27, 1984. The case concluded on October 25, 1984 when the Commission denied requests for intervenor compsenation. The Commission authorized a rate increase of $57,148,000 for NWB.

During the pendency of this rate case, a NWB Assistant Vice President, Roy Weir, took sitting Commissioners out for numerous meals. He dined most frequently with then-Commissioners Leo G. Adams and Roger L. Hanson. Records provided to the DPS and incorporated in its July 8, 1986 Report show that between September 2, 1983 and October 26, 1984, NWB provided more than 100 meals in total to then-sitting Commissioners and their spouses. The frequency of these free meals increased when important issues in *NWB 83-600* were raised. In a deposition taked by the DPS for the Report, Mr. Weir also stated that he provided baseball tickets, flowers, and other gifts to Commissioners, but did not give details. Weir Deposition 84-124; DPS Report 29. Mr. Weir's expenses for these meals and gifts had the explicit approval of his former superior, then Chief Executive Officer and Vice President, Thomas Madison. Madison Deposition, 29-40; DPS Report 30.

On April 26, 1984, NWB announced a corporate restructuring to become effecitve April 30, 1984. On May 2, 1984 Mr. Weir entertained Commissioner Adams and his wife. On May 4, 1984, the Commission ordered the DPS to investigate Bell's restructuring.

Mr. Weir entertained Commissioner Adams on May 7, 1984; Commissioner Hanson on May 9, 1984; Commissioner Hanson on May 14, 1984; Commissioner Adams on May 15, 1984. On May 16, 1984 motions to dismiss *NWB 83-600* were filed by Evan J. Henry, MPIRG, Recipient Families United for Justice and the Minnesota Senior Federation, the St. Cloud Area Ratepayers, and the DPS. On May 17, 1984 the DPS entered into a stipulation with NWB and formally withdrew its motion to dismiss. Mr. Weir hosted a meal for Commissioner Hanson on May 17, 1984; Commissioner Adams on May 18, 1984; Commissioner Adams and his wife on May 19, 1984.

On May 22, 1984, the Administrative Law Judge (ALJ), Bruce D. Campbell recommended dismissal of *NWB 83-600* to the Commission. On May 23, 1984, the Commission met to discuss the ALJ's recommendation and established a schedule for oral argument on reconsideration. That evening Mr. Weir took Commissioner Hanson and his wife to dinner. Mr. Weir hosted Commissioner Adams on May 25, 1984; Commissioner Adams and wife on May 30, 1984; Commissioner Adams on May 31, 1984; and Commissioner Adams and his wife on June 2, 1984.

Oral Arugment on the motions to dismiss *NWB 83-600* was held on June 5, 1984. On June 6, 1984, Mr. Weir hosted a meal for Commissioners Adams and Hanson. The following day, June 7, 1984, Commissioner Hanson wrote a memorandum to the other Commissioners recommending denial of the motions to dismiss *NWB 83-600*. The following day, June 8, the commission sent a letter to the ALJ stating its belief that due process would best be served by addressing the NWB corporate restructuring issue within the context of *NWB 83-600*. The letter stated that the Commission intended, upon rendering a decision on the record of the rate case, to move on its own motion for rehearing on all the additional issues occasioned by the restructuring. The Commission asked the ALJ to issue his Report in the rate case based on the then-existing record. On June 8, Mr. Weir and Commissioners Adams and Hanson again dined at NWB's expense. Five days later, on June 13, 1984, Mr. Weir entertained Commissioners Adams and Hanson and their wives at a private club in Lakeville, Minn. On June 19, 1984, Mr. Weir and Commissioner Adams dined together in Chicago.

On June 19, 1984, the ALJ issued Part I of his Report. The ALJ issued Part II of his Report on June 26, 1984. On that date, Mr. Weir hosted a meal for Commissioner Adams and his wife. On the following day, Mr. Weir dined with Commissioner Hanson. On July 3, 1984, Mr. Weir entertained Commissioner Adams. Two days later, July 5, the Commission was briefed by its staff on the issues in *NWB 83-600*. On July 6, 1984 while the staff briefing continued, Mr. Weir took Commisioner Adams out for one meal and Commissioner Hanson out for another. The Commission heard oral argument in *NWB 83-600* on July 9, 1984 and deliberated the case July 10 through July 13. On July 11, Mr. Weir and Commissioners Hanson and Adams and spouses went out for a meal at NWB's expense. Mr. Weir hosted Commissioner Adams on July 16; Commissioner Adams and his wife on July 18; Commissioners Hanson and Adams on July 19; Commissioner Hanson on July 23; and Commissioner Adams on July 25.

The Commission issued it Findings of Fact, Conclusions of Law, and Order in *NWB 83-600* on July 27, 1984. Mr. Weir entertained Commissioner Hanson on July 30; Commissioner Adams on July 31; Commissioner Hanson on August 3; and Commissioner Adams and his wife on August 4.

On August 6, 1984 NWB filed a petition for reconsideration of the Commission's July 27, 1984 Order. Mr. Weir hosted Commissioner Adams on August 7; Commissioner Adams and his wife on August 9; one meal for Commissioner Hanson and another meal for Commissioners Hanson, Adams and their wives on August 16; Commissioners Hanson and Adams on August 21.

The Commission met on August 23, 1984 and decided to rehear the issue of the financial impact of NWB's corporate reorganization. On August 25, 1984 Mr. Weir hosted Commissioner Adams and his wife. On August 27, 1984 the Commission issued its Notice Order and for Rehearing. On that date, Mr. Weir bought Commissioner Adams one meal and Commissioner Hanson and his wife another. On September 5, Mr. Weir hosted Commissioner Adams and his wife at two meals. On September 7, Mr. Weir entertained both Commissioners Adams and Hanson. Mr. Weir also hosted Commissioner Adams on September 11. The Commission reconsidered *NWB 83-600* on September 12 and 13, 1984. On September 13, Mr. Weir entertained Commissioner Hanson with one meal and

Commissioner Adams and his wife with another. Mr. Weir hosted Commissioner Hanson on September 14 and Commissioner Adams on September 19. He bought Commissioner Hanson a meal on September 21, and both Commissioners Hanson and Adams meals on September 25. On that date the Commission issued its Order After Rehearing in *NWB 83-600* which dealt with NWB's corporate restructuring.

The last petition for intervenor compsensation was filed on September 28. On that date Mr. Weir hosted Commissioners Hanson and Adams. On October 2, he entertained Commissioner Adams. On October 4 Mr. Weir provided Commissioner Adams and his wife one meal and Commissioner Hanson another. He hosted both Commissioners Hanson and Adams on October 12; Commissioner Hanson on October 19; and Commissioner Hanson again on October 25. On that date the Commission denied the requests for intervenor compensation. The next day, October 26, Mr. Weir took Commissioner Hanson to lunch and Comissioner Adams and his wife to dinner.

In summary, NWB provided more than 100 meals to sitting Commissioners and their spouses in the 14 month period between September 2, 1983 and October 26, 1984; Commissioner Adams received approximately 50 meals, Commissioner Hanson, 34 meals, and their wives, 25 meals. The DPS Report stated that in the 19 month period in 1982-1984 for which records were requested Commissioner Adams received approximately $2700 in meals from NWB and Commissioner Hanson received approximately $870 in meals from NWB.

Mr. Weir's supervisor, Thomas Madison, described Mr. Weir's actions as "developing a communications path." Madison Deposition 40, DPS-30. According to Mr. Weir's records, the meals were "quiet business meals." However, Mr. Weir denied that business was the main purpose of the meals. Weir Deposition-11, DPS-29, Weir Deposition 85, DPS 33. Mr. Weir's job as a lobbyist "was selling a product, selling a service, selling a company." Weir Depostition-55, DPS-30. Mr. Weir testified that he wanted to use the contacts to establish a relationship with the Commissioners "so that whatever problems they saw in our company or proposal they wanted to make about what we should be doing or how we operate ... whatever they'd have that they would want to share that they'd feel

comfortable saying, Roy, we don't think you're doing a good job, and they did that." Weir Deposition-55, 56, DPS-30, 31. Mr. Weir states that it was his policy to brief Commissioners on NWB's actions and issues just before they were filed with the Commission, but he would not discuss general rate case matters. Weir Deposition-50, DPS-66. Commissioners Hanson and Adams confirmed Mr. Weir's practice, stating that they were aware of the need to avoid discussions of contested matters when a formal contested case was pending. Hanson Deposition-21, Adams Deposition-19, DPS-66. Mr. Weir and former Commissioners Adams and Hanson stated that they never discussed the merits of contested cases at these meetings (meals) and denied the improper ex parte contacts occurred. DPS-64.

Commissioner Hanson did not dispute the accuracy of Mr. Weir's expense reports and acknowledged that Mr. Weir paid for the meals. He said that there were reasons for the frequent contact, including that Mr. Weir was a good friend. Commissioner Hanson stated the he valued Mr. Weir's advice. Hanson Deposition-45, DPS-35. Commissioner Hanson testified that he did not believe Mr. Weir attempted to influence his vote. Hanson Deposition-84, DPS-35.

Commissioner Adams states that he did not consider the frequent meals as improper nor did he consider that it might appear improper. Adams Deposition-93. He allowed Mr. Weir to pay for all the meals because Mr. Weir had invited him. Adams Deposition 39, 40, DPS-33. Finally Commissioner Adams stated that he did not discuss issues in pending cases with Mr. Weir, nor did he feel that his votes were influenced by his close association and regular contacts with him. Adams Deposition-93, DPS-34.

Gravity of NWB Contacts With Commissioners

In assessing the gravity and propriety of NWB's contacts with former Commissioners Adams and Hanson, the Commission must recognize the frequency and timing of the meals privided by NWB. While the participants to these meetings have testified that they did not discuss NWB's position in *NWB 83-600*, the Commission must recognize the necessary and logical effects of these meetings. A person is considered to intend the logical consequences of his or her actions. Intent can be determined by drawing obvious inferences from objective fact. Here, the facts speak for themselves.

Mr. Weir, a NWB Assistant Vice President, provided more than

100 meals in total to sitting Commissioners and their spouses between September 2, 1983 and October 23, 1984 in addition to providing various gifts. Mr. Weir's expenses for these meals and gifts had the explicit approval of his former superior, then Chief Executive Officer and Vice President, Thomas Madison. As discussed above many of these meals coincided with Commission discussions and deliberations on issues critical to NWB's general rate case. The entertainment and contacts were much less frequent during less critical stages of the Commission's decision process. The obvious inference from these facts is that NWB intended to influence decision makers through its generosity and almost limitless hospitality.

The Commission finds that the sheer number of free meals adds to the gravity of these ex parte communications. Further, in analyzing their timing, the Commission recognizes, as it must, that the seriousness of these ex parte contacts is compounded by the pattern of extended hospitality at times critical to NWB's rate case. The Commission concludes that the ex parte contacts summarized above are a serious abuse and violation of the regulatory process.

The Influence of the Contacts on the Agency's Utlimate Decision

The Commission finds that it is difficult to accurately assess the effect NWB's action had on particular votes on particular issues. However, the Commission has found that NWB's method of selling the Company and opening a "communications path" to the Commission through free meals and other gifts was designed to promote a favorable regulatory environment for NWB. The Commission concludes tht the relationship between Mr. Weir and Commissioners Adams and Hanson creates, at a minimum, the impression of an atmospheré unduly receptive to Bell positions and beneficial to the Company.

Benefit to NWB

The Commission is aware that Mr. Weir and former Commissioners Adams and Hanson have testified that issues pending before the Commission were never discussed at any of the meals they shared. While the timing of the contacts increased at crucial times in the rate case, the Commission has no concrete evidence of the substance of the discussions at those meetings. However, the Commission finds that it is logical to assume that NWB expected to receive a corporate benefit from the time and money it spent in entertaining sitting Commissioners.

NWB is a heavily regulated utility and must be charged with the knowledge of the regulatory scheme envisioned by the Legislature and codified in the Administrative Procedure Act (Minn. Stat. Ch. 14). When the regulatory atmosphere even slightly favors one party, the due process rights of other parties are violated. Here NWB made a concerted effort to court two Commissioners who were responsible with ensuring that NWB's rates are fair and reasonable. Minn. Stat. § 237.06 (1986). NWB's actions cannot be realistically viewed as separate from *NWB 83-600.* Those actions were directed to create a favorable milieu of the corporate image of NWB, making the general atmosphere for regulating NWB more friendly and more open to the NWB proposals than the regulatory process alone would allow. The Commission finds that it is only logical to assume that NWB expected that the time and money it spent on these entertainments would be reflected in favorable Commission decisions. Clearly Mr. Weir viewed himself as a lobbyist. The Commission cannot believe that his actions and hospitality were not directed at favorably influencing former Commissioners Adams and Hanson to NWB's views in its rate case. This type of favored status is particularly insidious because it is not readily apparent to other participants in the rate case. The Commission concludes that these contacts were intended to benefit NWB in *NWB 83-600.*

Integrity and Fairness of Process

The Commission will next address whether NWB's ex parte contacts threatened the integrity and fairness of the rate case process and denied opposing parties an opportunity for effective response.

Although these contacts occurred in restaurants these communications were private. Other participants in the ratemaking process were not given advance notice of the meetings, did not participate, and were not able to respond to any of the discussions effectively. The nature of these meetings and NWB's purpose in promoting them cast a cloud over the regulatory process and denied other parties and the public any effective opportunity to respond in *NWB 83-600.* The Commission finds that the Company's intent to influence decision makers outside of the regulatory process as evidenced by its actions violated the rights of the other parties. The Commission concludes that the fairness and integrity of the regulatory process have been seriously impaired and frustrated by the action of NWB discussed above.

Future Commission Action

The Commission finds that the actions of NWB and former Commissioners Hanson and Adams demand corrective measures. The ex parte communications described above are a serious infringement and abuse of the regulatory process. They were designed to influence decisionmakers without allowing other parties to respond to them, thereby denying due process to the other parties in the rate case and to NWB's ratepayers. Further, the actions have tainted the decisions in *NWB 83-600*, have created an atmosphere of public distrust and lack of confidence in the regulatory process and must be corrected.

The Commission must determine a remedy that is commensurate with the degree of harm NWB has inflicted on the regulatory process. The range of corrective actions can be viewed as points along a continuum, with no remedy being required at one end, where there had been no harm, and dismissal of a proceeding at the other, where there has been great and irrevocable harm.

The Commission has considered the alternative of dismissing *NWB 83-600*. This response would be appropriate where either the gravity or the consequences of the communications were more than found here. The Commission has recently dismissed a case where a utility applicant discussed employment with a former Commissioner who was about to decide its pending rate case, and the former Commissioner repeatedly supported the utility's position in the decision-making process. *Northern States Power Company* Docket Nos. G-002/GR-85-108, G-0002/GR-85-282 Order Vacating December 30, 1985 Order, Dismissing General Rate Case, Discontinuing Interim Rates and Requiring Refund of Interim Rates (February 19, 1986). The Commission found that dismissing the NSP case was the only action that would effectively remedy the abuse of the decision-making process that resulted from ex parte contacts and conflicts of interest that had so prejudiced the proceeding that the Commission could not consider it impartially. See, *WKAT, Inc. v. FCC*,296 F. 2d 375 (D.C. Cir. 1961).

A cruicial difference between this case and the NSP case is that the Commission does not know the content of discussions at the meetings between Mr. Weir and Commissioners Adams and Hanson. While the evidence shows a general intent and effort to influence, the Commission cannot find here either the benefit offered or

the direct effect on deliberations present in the NSP case. The cause and effect relationship between these contacts in *NWB 83-600* is not as clear as in *NSP* G-002/GR-85-108, G-002/GR-85-282.

The remedy of dismissal must serve a useful purpose. When the administrative result and ensuing confusion of dismissing three years of rates already collected is considered, the consequential loss of three years of increased rates to NWB would be much harsher than the consequential loss of one year of rates to NSP. Here, neither the gravity of the offense nor the weight of the evidence make the contacts between NWB and the Commissioners Hanson and Adams as egregious as the employment offer made by NSP to Commissioner Adams. Thus, the NWB case does not merit the same result as NSP, let alone a harsher result. Therefore, the Commission does not find that the extreme remedy of dismissal is appropriate in this case. The Commission will deny MPIRG's petition to vacate and dismiss *NWB 83-600*.

An alternative at the other end of the continuum, that of ordering no remedial action because no harm resulted from the ex parte communications, is unreasonable in this case. As discussed above, the ex parte contacts between NWB and sitting Commissioners were serious both in light of their number and their timing. The Commission has found that they caused procedural unfairness in *NWB 83-600*. A remedy is clearly called for.

The Commission finds that redeliberating this case is necessary to remove the taint of the ex parte contacts between NWB and Commissioners Adams and Hanson. Redeliberation by the present Commission can remove any partiality or appearance of partiality from the original decisions in *NWB 83-600* and restore public confidence and trust in regulation. Since the decision in *NWB 83-600*, Commissioners Hanson and Adams have left the Commission, and therefore, any bias they may have brought to the decisionmaking process has been removed. Therefore, the Commission will vacate its July 27, 1984 decision in this matter and concludes that *NWB 83-600* should be redeliberated. The Commission will conduct the redeliberation and issue a separate Order after redeliberation in Docket No. P-421/GR-83-600.

The Commission also finds that NWB must take remedial action to see that the serious abuses of the regulatory process that occurred in the past do not happen again. The affidavits of NWB personnel

indicate that they felt the frequent entertaining of sitting Commissioners discussed above was acceptable behavior; NWB corporate policy supported such behavior by reimbursing employees for these entertainment expenses. The Commission, however, does not find such practices by a regulated utility to be acceptable, for the reasons given above and as expressed in its orders adopting rules governing a code of conduct for the Commission and its staff and governing ex parte contacts.

To help avoid such abuses by NWB in the future, the Commission will direct NWB to file with the Commission: 1) a written code of conduct for its employees to follow in dealing with the Commission and its staff and 2) written procedures for review of employee expense records and reimbursement requests for regulatory activities. For a company as large as NWB, internally publicized, written rules will assist employees to conduct themselves properly. NWB is to ensure that its policies conform to the Commission's Code of Conduct and Ex Parte rules, Minnesota Rule, parts 7845.0100 to 7845.100 and parts 7845.7000 to 7845.7600 respectively.

The Commission will also deny MPIRG's request to reconsider the November 13, 1984 Order Denying Intervenor Compensation, in which MPIRG was denied intervenor compensation. That Order was appealed to the Minnesota Court of Appeals and the Minnesota Supreme Court; the Commission's decision with respect to MPIRG was affirmed. *In the Matter of the Application of Northwestern Bell Telephone Company,* 386 N.W.2d 723 (Minn. 1986). Since the Court has affirmed the criteria and standards used by the Commission to evaluate MPIRG's petition for intervenor compensation, the Commission will not reconsider the request at this time. This decision does not preclude MPIRG from submitting a new request for intervenor compensation after the Commission has issued its order after redeliberation in *NWB 83-600*, if MPIRG believes it would then qualify under the Commission's previously adopted criteria.

***

ORDER

1. The Commission Order of July 27, 1984 in *NWB* Docket No. P-421/GR-83-600 is vacated and the case is reopened for further deliberation and the issuance of a new decision and order.
2. The Commission Orders in *Interstate Intercity telecommunications Services,* Docket No. P-442 et al/NA-84-212; *United Telephone Company,* Docket No. P-430/GR-84-597; *New Ulm Telecom,* Docket No. P-419/NA-84-334; *NWB,* Docket No. P-421/CI-83-144 and P-421/M-83-167; and *NWB.* Docket No. P-421/CI-82-619, P-421/M-82-512, and P-421/M-83-127 shall not be reopened.
3. The August 14, 1986 Petition of the Minnesota Public Interest Research Group for vacation and dismissal of the Commission's July 27, 1984 and November 13, 1984 Orders in *NWB 83-600* is denied.
4. The July 9, 1986 Petition of the Residential Utilities Division of the Attorney General's Office to reopen and redeliberate its July 27, 1984 Order in *NWB 83-600* is granted.
5. Within 30 days of the service date of this Order, Northwestern Bell shall file with the Commission a written code of conduct and written expense reimbursement policies as described herein.
6. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION
Marry Ellen Hennen
Executive Secretary

APPENDIX 9

BEFORE THE
MINNESOTA PUBLIC UTILITIES COMMISSION

Barbara Beerhalter	Chair
Harry Seymour Crump	Commissioner
Cynthia A. Kitlinksi	Commissioner
Robert J. O'Keefe	Commissioner
Darrel L. Peterson	Commissioner

ISSUE DATE: April 03, 1987

In the Matter of the Application of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota

Docket No. P-421/GR-83-600

ORDER AFTER REDELIBERATION

Procedural History

On September 29, 1983, Northwestern Bell Telephone Company (Northwestern Bell, NWB or the Company) filed a petition for increased rates with the Minnesota Public Utilities Commission (the Commission), pursuant to Minn. Stat. § 237.075 (Supp. 1983). NWB's originally proposed change in rates would have increase its intrastate annual gross revenues by $109,461,000. In testimony filed February 8, 1984, the Company proposed revenue increase was revised downward to $98,174,000. In its Initial Brief, filed on April 20, 1984, the Company's requested increase in annual revenue was stated to be $107,587,000.

The Commission accepted NWB's filing and suspended the proposed rates by Order dated October 21, 1983. On that same date, the Commission issued its Notice and Order for Hearing directing

that a hearing be conducted on the Company's petition. Administrative Law Judge Bruce D. Campbell (ALJ) was assinged to the proceeding by the Office of Administrative Hearings.

Pursuant to Minn. Stat. § 237.075, subd. 3 (Supp. 1983), the Commission, by Order dated November 22, 1983, authorized and set the Company's interim rates at a level sufficient to collect $53,778,000 in additional revenues, subject to refund, pending a final Order by the Commission. The interim rates became effective for service rendered on and after November 28, 1983.

A prehearing conference was held by the ALJ on November 18, 1983. A Prehearing Order establishing the hearing schedule and procedural guidelines was issued on December 13, 1983. Pursuant to Minnesota Rules, part 1400.6200, Petitions for Intervention were filed and the following were made parties to the proceeding: the Minnesota Department of Public Service (DPS or the Department); the Residential Utilities Division of the Office of the Attorney General (RUD-AG); the Minnesota Department of Administration (DOA); Evan J. Henry, ratepayer; the Minnesota Public Interest Research Group (MPIRG); the Surburban Rate Authority (SRA); North Star Legal Foundation (NSLF); Recipient Families United for Justice (RFUJ); Minnesota Senior Federation (MSF); AT&T Communications of the Midwest, Inc. (AT&T/MW): The Minnesota Business Utility Users Council (MBUUC); The County of Ramsey; the United States Department of Defense on Behalf of the Interest of all Federal Executive Agencies (FEA); Polly Vesser, Renay Post, Sophie Jendro and Cindy Graham, ratepayers (St. Cloud Area Ratepayers or SCAR); the Coalition of FX Users (FX Users); Telecommunications Association of Minnesota (TAM); the Minnesota Radio Common Carriers Association (MRCCA): and NewVector Communications, Inc. (NewVector). The Petitions for Intervention of MRCCA and NewVector were granted by Commission Orders of February 21, 1984 and march 21, 1984 respectively.

The ALJ conducted evidentiary hearings in St. Paul on January 9, 10-13, 16-20, 23-27 and 30, 1984; March 12-16, 19-23, 26 and 27, 1984; and April 5, 1984.

Appearances at the evidentiary hearings were as follows: James A. Gallagher and Gregory A. Ludvigsen, Attorneys, 200 South Fifth Street, Room 1800, Minneapolis, Minnesota 55402 and Richard A. Karre, Attorney, 1314 Douglas, Omaha, Nebraska

68102, represented Northwestern Bell Telephone Company; Kenneth A. Nickolai, Susan W. Rester, James T. Jarvis, and Christopher K. Sandberg, Special Assistant Attorneys General, 1100 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, represented the Department of Public Service; Michael J. Bradley, Assistant Attorney General and Thomas M. O'Hern, Jr., and Dennis D. Ahlers, Special Assistant Attorneys General, Residential Utilities Division, Office of the Attorney General, 340 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, represented the Attorney General Hubert H. Humphrey III; W. Richard Morris, Attorney, 10825 Old Mill Road, Omaha, Nebraska 68154 and Samuel L. Hanson, Attorney, Briggs and Morgan, 2400 IDS Center, Minneapolis, Minnesota 55402 respresented AT&T Communication of the Midwest; Carla Kjellberg, and Gail Suchman, Attorneys, 2412 University Avenue Southeast, Minneapolis, Minnesota 55414, represented the Minnesota Public Interest Research Group; Kathleen M. Davis, Attorney, Minneapolis Legal Aid Society, 323 Fourth Avenue South, Minneapolis, Minnesota 55415, represented the Minnesota Senior Federation; Eliot Rothenberg, Attorney, 850 Builders Exchange Building, Minneapolis, Minnesota 55402, represented North Star Legal Foundation; Larry D. Starns, Special Assistant Attorney General, 204 Administration Buiding, 50 Sherburne Avenue, St. Paul, Minnesota 55155, represented the Minnesota Department of Administration; Lawrence R. McDonough, Attorney, St. Cloud Area Legal Services, 125½ East Broadway, Little Falls, Minnesota 56345, represented Polly Vesser, Renay Post, Sophie Jendro and Cindy Graham, ratepayers; Eldon J. Spencer, Jr., Attorney, 800 Northwestern Center, St. Paul, Minnesota 55101 represented the Coaltition of FX Users; Glen E. Purdue and James M. Strommen, Attorneys , 2000 First Bank Place West, Minneapolis, Minnesota 55402, represented the Suburban Rate Authority; Carol Casebolt, Attorney, Legal Aid Scoiety of Minneapolis, 222 Grain Exchange Building, Minneapolis, Minnesota 55415, represented Recipient Families United for Justice; William E. Flynn, Attorney, 3800 IDS Tower, 80 South Eighth Street, Minneapois, Minnesota 55402, represented the Minnesota Business Utility Users Council; Elissa Mautner, Assistant Ramsey County Attorney, 200 Lowry Square, St. Paul, Minnesota 55102, represented the County of Ramsey;

Russell L. Doty, Attonery, Suite 814, Degree of Honor Buiding, 325 Cedar Street, St. Paul, Minnesota 55101, represented the Minnesota Radio Common Carriers Association; Dwight M. Whitley, Attorney, 3350 161st Avenue Southeast, Bellevue, Washington 98008 and John B. Van de North, Attorney, Briggs and Morgan, 2400 IDS Center, Minneapolis, Minnesota 55402, represented NewVector communications, Inc.; Evan J. Henry, Route 1, Box 60, Winona, Minnesota 55987, appeared *pro se*; and Karl W. Sonneman, Special Assistant Attorney General, and Mark E. Oberlander, Karin F. Leonard, and Everett J. Kulas, 780 American Center Building, 160 East Kellogg Boulevard, St. Paul, Minnesota 55101, represented the Minnesota Public Utilities Commission.

Public hearings to receive customer comments and questions regarding the proposed increase were held on the following dates and in the following locations. Parenthetical numbers indicate the number of persons attending each hearing. Bracketed numbers indicate the number of persons speaking at each hearing.

January 23, 1984	St. Paul	(150)	[12]	1:00 p.m.
January 23, 1984	St. Paul	(15)	[13]	7:00 p.m.
January 24, 1984	Winona	(35)	[18]	
January 25, 1984	Owatonna	(27)	[8]	
January 26, 1984	Marshall	(30)	[11]	
January 27, 1984	Willmar	(2)	[2]	
February 7, 1984	Duluth	(40)	[6]	
February 8, 1984	Virginia	(30)	[6]	
February 9, 1984	Crookston	(4)	[3]	
February 10, 1984	Moorhead	(3)	[1]	
February 21, 1984	Faribault	(140)	[12]	
February 22, 1984	Minneapolis	(500)	[12]	1:00 p.m.
February 22, 1984	Minneapolis	(30)	[12]	7:30 p.m.
February 23, 1984	Cambridge	(100)	[16]	
February 24, 1984	Little Falls	(85)	[14]	

Nineteen public exhibits were received into the record. Several additional public exhibits were offered but later excluded from evidence by the ALJ.

Due to time constraints, the ALJ declined to hold a public hearing in Duluth during the afternoon of February 7, 1984. An

"unofficial hearing" or public gathering was held without the presence of the ALJ. It is asserted that 134 people attended that gathering and an unoffical tape record of the proceeding and an attendance roster were introduced into the record at the evening public hearing as Public Exhibit 2. The ALJ estimated that more than 80% of the persons attending the public hearings were senior citizens. In addition to the testimony received at the public hearings, the ALJ received more than 300 letters, all of which were reviewed and included in the record of this proceeding. In the summary of public testimony that is contained in Part III of this Order, no distinction has been made between public oral testimony and public letters.

On April 26, 1984, Northwestern Bell presented to the Commission a proposed corporate restructuring. As part of this presentation, NWB provided documents which it had filed before the Federal Communications Commission (the FCC) which were designed to comply with an FCC order (CC Docket No. 83-115, released on December 20, 1983). The FCC, in that order, imposed the structural separation requirements of 47 C. F. R. § 64.704 on the divested Bell Opeating Companies (BOCs) in their offering of customer premises equipment (CPE) and enhanced services if they intended to provide such services after the divestiture. NWB is one of the 22 divested BOCs.

In its presentation before the Commission, NWB informed the Commission that to comply with the FCC's December 30, 1983 Order it would incorporate a new holding company, Northwestern Bell Corporation, on April 30, 1984. Northwestern Bell Corporation would have as its subsidiaries Northwestern Bell Telephone Company (NWBT), and Northwestern Bell Information Technologies, Incorporated. NWBT would encompass all present operations of NWB and would be regulated by the Commission. Northwestern Bell Information Technologies, Incorporated would be a new company formed on May 3, 1984, and would not be regulated by the Commission.

On May, 4, 1984, the Commission issued an Order directing the DPS to investigate the corporate reorganization of NWB and affiliated corporations and to respond to specific Commission inquiries *In the matter of an Investigation by the Minnesota Public Utilities Commission into the Corporate Restructuring of North-*

western Bell Telephone Company, Docket No. P-421/C1-84-192.

By letters dated May 8 and 9, 1984, the ALJ, on his own motion, convened a Post-hearing Conference and described to the parties the evidentiary status to be afforded the discussions occurring at that conference. The ALJ stated in a May 9, 1984 letter that his sole purpose in conducting the Post-hearing Conference was to attempt to reach some conclusion about the extent to which the record in this proceeding would reflect the business activities of the divested, reorganized company during the period within which any revised rate may be in effect. He emphasized that the purpose of the Post-hearing Conference was to extend the hearing to accommodate additional substantive evidence regarding the reorganization of NWB. At the Post-hearing Conference. all counsel present were afforded an opportunity to make oral argument with respect to the matters discussed at the Conference.

Appearances at the Post-hearing Conference were as follows: Melvin R. Quinlan, Attorney, 1314 Douglas on the Mall, Omaha, Nebraska 68102 and James A. Gallagher, Attorney, 200 South Fifth Street, Room 1800, Minneapolis, Minnesota 55402, appeared on behalf of NWB; Kenneth A. Nickolai and Susan W. Rester, Special Assistant Attorneys General, 1100 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, appeared on behalf of the DPS; Thomas M. O'Hern, Jr., and Dennis Ahlers, Special Assistant Attorneys General and Michael J. Bradley, Assistant Attorney General, 340 Bremer Tower, Seventh Place and Minnesota Street, St. Paul, Minnesota 55101, appeared on behalf of the RUD-AG; James M. Strommen, Attorney, 2000 First Bank Place West, Minneapolis, Minnesota 55402, appeared on behalf of the SRA; Samuel L. Hanson, Attorney, 2400 IDS Center, Minneapolis, Minnesota 55402, appeared on behalf of AT&T/MW; Carla Kjellberg, Attorney, 2412 University Avenue S.E., Minneapolis, Minnesota 55414, appeared on behalf of MPIRG: Kathleen M. Davis, Attorney, Minneapolis Legal Aid Society, 323 South Fourth Avenue, Minneapolis, Minnesota 55415, appeared on behalf of the MSF; Larry D. Starns, Special Assistant Attorney General, 204 Administration Building, 50 Sherburne Avenue, St. Paul, Minnesota 55155, appeared on behalf of the DOA; William E. Flynn, Attorney, 3800 IDS Tower, 80 South Eighth Street, Minneapolis, Minnesota 55402, appeared on behalf of MBUUC; Carol Casebolt,

Attorney, Minneapolis Legal Aid Society, 222 Grain Exchange Building, Minneapolis, Minnesota 55415, appeared on behalf of RFUJ; Lawrence R. McDonough, Attorney, St. Cloud Area Legal Services, 125-½ East Broadway, Little Falls, Minnesota 56345, appeared on behalf of the St. Cloud Area Ratepayers; John B. Van de North, Briggs and Morgan, Attorneys at Law, 2400 IDS Center, Minneapolis, Minnesota 55402, appeared on behalf of NewVector; and Mark E. Oberlander, 780 American Center Building, 160 East Kellogg Boulevard, St. Paul, Minnesota 55101, appeared on behalf of the Commission. In addition, each Commissioner of the Public Utilities Commission was present for all or a significant portion of the Post-hearing Conference.

Pursuant to written Motions, dated May 16, 1984, the following parties to the above captioned proceedings timely requested that the ALJ recommend to the Minnesota Public Utilities Commission a summary disposition or dismissal of the pending general rate increase requested by Northwestern Bell Telephone Company: The DPS; the RFUJ; the St. Cloud Area Ratepayers, Evan J. Henry; the MPIRG: and the MSF. Such Motions were accompanied by supporting memoranda of law. On May 17, 1984, the DPS entered into a Stipulation with Northwestern Bell (Stipulation), and formally withdrew its previous Motion to Dismiss. On May 18, 1984, Northwestern Bell timely filed a memorandum of law opposing the Motions to Dismiss.

The ALJ submitted the Recommendation of Administrative Law Judge Regarding Motions for Summary Disposition or Dismissal to the Commission on May 22, 1984.[1] The ALJ recommended that the application of NWB for authority to change its schedule of telephone rates for Minnesota customers be dismissed for failure of the Company to sustain its statutory burden of proof. Minn. Stat. § 237.075, subd. 4 (Supp. 1983).

On May 23, 1984, the Commission met to consider the ALJ's Recommendation of Dismissal. The Commission viewed the Recommendation as a possible final disposition of a contested case proceeding. Minn. Stat. § 14.61 (1982) provides that in a contested case a final decision cannot be made until the report of the ALJ

[1]The Commission has excerpted portions of that Recommendation herein without specific attribution.

has been made available to parties for at least 10 days and affords an opportunitty for adversely affected parties to file exceptions and present oral argument. Consequently, Oral Argument on the ALJ's Recommendation for Dismissal was held on June 5, 1984. The following parties participated in the Oral Argument: MPIRG, MSF, RFUJ, St. Cloud Legal Service, NWB, DPS, MBUUC, and the RUD-AG.

On June 8, 1984, the Commission sent a letter to the ALJ stating its belief that due process would best be served by addressing the restructuring issue within the context of this proceeding. The letter stated that the Commission intended, upon rendering a decision on the record of this proceedig to move on its own motion for rehearing on all the additional issues occasioned by the restructuring. The Commission requested that the ALJ issue his Report on the basis of the existing record.

Post hearing briefs were received by the ALJ by May 30, 1984 at which time the record closed.

The ALJ submitted Part I of his Report to the Commission on June 19, 1984. He submitted Part II on June 26, 1984.[2]

The Commission heard Oral Argument on July 9, 1984.

The Commission issued its Findings of Fact, Conclusions of Law and Order in this proceeding on July 27, 1984 (July 27, 1984 Order) authorizing a rate increase of $57,511,000 exclusive of the test year effects of the corporate restructuring that occurred on or about April 30, 1984.

Petition for Reconsideration or Rehearing of the July 27, 1984 Order were filed by the RUD-AG and NWB on August 6, 1984; by the MRCCA, NewVector, the DPS and Evan J. Henry on August 16, 1984.

The Company filed Replies to the Petition of the RUD-AG on August 16, 1984 and to the Petitions of the DPS, the MRCCA, NewVector, and Evan J. Henry on August 28, 1984. The RUD-AG and the DPS filed Responses to the Company's Petition for Reconsideration on August 17, 1984. On that date, the MBUUC filed its Response to the RUD-AG's Petition for Reconsideration.

The July 27, 1984 Order directed to DPS to submit to the Commission and serve all parties to this proceeding a report of its

[2]The Commission has excerpted portions of these Reports herein without specific attribution.

investigation regarding the corporate reorganization of NWB undertaken in *NWB*, P-421/CI-84-192. Any party wishing to submit comments regarding the DPS report was directed to do so in writing to the Commission and serve them on all parties no later than August 14, 1984.

On August 1, 1984, the DPS submitted its Report in *NWB*, P-421/CI-84-192 to the Commission. The report was also served on all parties. In the August 1, 1984 Report, the DPS indicated its preliminary findings that the $57,511,000 rate increase authorized in the July 27, 1984 Order should be reduced by $371,000 to reflect the financial impact of the Company's reorganization pertaining to the test year used in this proceeding. The DPS indicated that the $371,000 reduction was a preliminary adjustment which it would subsequently revise to conform with the Commission's findings in the July 27, 1984 Order. Comments were filed by the RUD-AG and NWB on August 14, 1984. The FEA submitted comments on October 1, 1984. No party contested the DPS Report with regard to the impact of the restructuring upon the test year revenue deficiency. Mr. Henry did not submit comments.

On August 3, 1984, Northwestern Bell filed with the Commission proposed tariff pages containing revised rates that would generate $57,511,000 of additional revenues and a proposed customer notice in compliance with the July 27, 1984 Order. Northwestern Bell also sent a copy of its compliance tariffs and notice to all parties.

On August 24, 1984, the DPS served a memorandum on all parties which calculated the amended effect of the corporate restructuring as a downward adjustment of $363,000 to the rate increase authorized by the Commission in its July 27, 1984 Order. The amended calculation reflected the cash working capital impact of the adjustments to the test year income statement and the lower rate increase. The revised adjustment also reflected an amendment to the pro forma interest expense and the use of the Commission's allowed rate of return.

On August 27, 1984, the Commission issued its Notice and Order for Rehearing this case. Rehearing was granted for the limited purposes of receiving the DPS August 1, 1984 Report in *NWB*, P-421/CI-84-192 into the record of this proceeding and determining whether there was cause to go forward to a contested case proceeding regarding the financial impact of NWB's corporate restructuring on this proceeding.

On August 30, 1984, the Commission issued its Order After Reconsideration and Order Approving Compliance Filing in the Intrastate Access Charge Case, Docket No. P-421/CI-83-203 et al. That Order indicated that NWB was entitled to increased gross annual revenues of $382,405 in order to eliminate the revenue deficiency identified in that proceeding. The Order also directed NWB to implement the rate increases from that proceeding within the context of the general rate case compliance filing in this proceeding *NWB*, P-421/GR-83-600.

On September 12, 1984, the Commission held a rehearing to receive the DPS August 1, 1984 Report into the record of this proceeding, and to determine whether there was cause to go forward to a contested case proceeding regarding the financial impact of NWB's corporate restructuring on the proceeding. The following parties appeared at the rehearing: NWB, the DPS, the RUD-AG, MPIRG, Evan J. Henry, and the Department of Defense and the Federal Executive Agencies. None of the parties disputed the accuracy of the $363,000 downward adjustment to the authorized rate increase as set forth in the DPS memorandum of August 24, 1984 or requested further hearings on this matter.

On September 26, 1984, the Commission issued its Order After Reconsideration and Rehearing in this proceeding, *NWB*, P-421/GR-83-600. That Order indicated that the $57,511,000 increase in gross annual revenues authorized in the July 27, 1984 Order should be reduced by $363,000 in order to recognize the test year effects of the Northwestern Bell corporate reorganization.

By letter dated September 17, 1984, Northwestern Bell requested that the revised rates contained in the proposed tariff pages submitted on August 3, 1984 be approved to allow it to collect the revenue increases authorized in the August 30 and the September 26, 1984 Orders.

On September 26, 1984, the Commission sent a letter to all parties in this proceeding soliciting comments regarding NWB's proposed tariff pages and its proposal to implement the rates contained in the August 3, 1984 tariff pages to allow the Company to collect the revenue increases authorized in the August 30 and the September 26, 1984 Orders. The Department of Public Service was the only party to submit comments. The Department of Public Service indicated that it had no objection to Northwestern Bell's proposals.

On October 17, 1984, the Commission issued its Order approving Tariff Pages and Customer Notice in *NWB* P-421/GR-83-600. That Order approved NWB's proposal implementing the rates contained in the August 3, 1984 tariff pages to allow NWB to collect the revenue increases authorized in the August 30 and September 26, 1984 Orders in this proceeding.

On April 9, 1986, the Commision issued its Order Initiating Investigation *In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contracts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners* in Docket No. U-999/CI-86-177. In that Order, the Commission directed the DPS to conduct an independent investigation to assess whether any improper communications occurred during Commission proceedings addressing issues of significant financial impact to regulated companies or addressing significant policy issues likely to lead to a significant financial impact on regulated companies. The Commission directed that the investigation cover at least the last several months of the Commisison terms of former Commissioners Juanita R. Satterlee, Roger L. Hanson, and Leo G. Adams. The Commission could then use this investigation to remedy any improper influence caused by these contacts.

On July 8, 1986, the DPS submitted its "Report of the Department of Public Service to the Minnesota Public Utilities Commission" (the DPS Report) in Docket No. U-999/CI-86-177. The DPS also submitted the depositions and documents it obtained in the course of its investigation as supporting exhibits to the DPS Report. The DPS identified seven decisions which may have been tainted by employment discussions between regulated companies and then-sitting Commissioners and recommended that the Commission reopen the following five decisions: *Intrastate Intercity Telecommunications Services,* Docket No. P-442 et al./NA-84-212 (October 15, 1985) (*Toll Competition* docket); *United Telephone Company,* Docket No. P-430/GR-84-597 (August 12, 1985) (*United* docket); *New Ulm Telecom,* Docket No. P-419/NA-84-334 (March 14, 1986) (*New Ulm* docket); *Northwestern Bell Telephone Company,* Docket Nos. P-421/CI-82-619, P-421/M-83-127, and P-421/M-82-512 (May 16, 1983) (*WATS Resale* docket); and *Northwestern Bell Telephone Company,* Docket Nos. P-421/M-83-144, P-421/M-83-167 (June 1,

1983) (*Basic Six* docket). The DPS Stated that no corrective action was necessary in *Northwestern Bell Telephone Company*, Docket No. P-421/GR-82-204 (April 20, 1983) or *In the Matter of the Acquisition of Peoples Natural Gas Company by Utilicorp United, Inc.*, Docket No. G-011/PA-85-681 (December 4, 1985). The DPS also made five other recommendations which related to actions to eliminate future improper contacts.

On August 13, 1986, NWB filed a response to the DPS Report, asking the Commission to deny the DPS recommendations to reopen the *WATS Resale, Basic Six, New Ulm,* and *Toll Competition* decisions.

On July 9, 1986, the RUD-AG filed a petition requesting the Commission to reopen and reconsider its July 27, 1984, Findings of Fact, Conclusions of Law, and Order *NWB,* P-421/GR-83-600. The petition claimed that this proceeding had been tainted by ex parte communcations between NWB and former Commissioners during deliberations on the case. The DPS Report had revealed these communications. On July 18, 1986, NWB filed its response asking the Commission to deny the RUD-AG petition. On August 1, 1986, the RUD-AG filed a reply brief to NWB's response. On September 15, 1986, NWB responded to the RUD-AG reply brief.

On August 14, 1986, MPIRG filed a petition requesting that the Commission vacate and dismiss its July 27, 1984 and November 13, 1984 Orders in *NWB,* P-421/GR-83-600, for reasons similar to those given by RUD-AG petition. On September 15, 1986, NWB responded to MPIRG's petition, asking that the petition be denied.

On October 3, 1986, the Commission issued its Order Establishing Procedures and Soliciting Briefs in Docket No. U-999/CI-86-177. That Order requested parties to submit briefs on whether *NWB,* P-421/GR-83-600, *Toll Competition, United, New Ulm, WATS Resale, Basic Six* or any other decisions in the relevant time period were tainted due to a conflict of interest of ex parte communications between former Commissioners Adams, Hanson, or Satterlee and regulated companies.

On October 23, 1986, United Telephone Company (United), SRA, MPIRG, RUD-AG, NWB and the DPS filed comments or briefs in Docket No. U-999/CI-86-177. In its brief, the DPS recommended that the Commission re-deliberate this proceeding, *NWB,* P-421/GR-83-600, on the merits. The DPS had not recommended

reopening of this case in its July 8, 1986 Report which focused on the impact of job negotiations, rather than on gratuities and ex parte contacts. On October 24, 1986, the MBUUC filed a letter addressing this matter and U.S. Sprint filed a brief.

On October 28, 1986 the Commission issued its Notice of Oral Argument in Docket No. U-999/CI-86-177.

On November 3, 1986, NWB filed its Reply to the submissions of the other parties in Docket No. U-999/CI-86-177.

Oral argument was held in Docket No. U-999/CI-86-177 on November 6, 1986 with representatives of the DPS, the RUD-AG, MPIRG, the SRA, the MBUUC, AT&T, and NWB participating.

On April 2, 1987, the Commission issued its Order After Investigation in Docket No. U-999/CI-86-177. That Order vacated the Commission's July 27, 1984 Order in this proceeding, *NWB*, P-421/GR-83-600, and directed that this proceeding be redeliberated by the present Commission to remove any possible improper influence on the decisions in the Commisison's July 27, 1984 Order and to restore public confidence and trust in regulation.

The Commission has redeliberated the *NWB*, P-421/GR-83-600 original case record up through replies to exceptions and the transcript of the July 9, 1984 Oral Argument. The Commission did not sulicit or receive new pleadings or argument. Parties are hereby advised that the Commission has adopted some of the express language contained in the vacated July 27, 1984 Order into this Order, particularly when describing the positions of the parties and when the Commission's decisions on redeliberation are the same as its earlier vacated decisions.

Notice is hereby given that pursuant to Minnesota Rules, part 7830.4100 petitions for rehearing or other post-hearing relief, by any party adversely affected, must be filed within 20 days of the mailing date hereof (original plus 13 copies) with Mary Ellen Hennen, Executive Secretary, Minnesota Public Utilities Commission, 780 American Center Building, 150 East Kellogg Boulevard, St. Paul, Minnesota 55101, with proof of service on all parties. The grounds relied upon shall be specifically set forth and the claimed errors clearly stated in the petition. If desired, adverse parties may file and serve answers (original plus 13 copies) within 10 days after service of the petition. The Commission may, in its discretion, grant oral

argument on the petition or may decide that petition without oral argument.

Now upon review of the entire record herein, the Commission makes the following Findings, Conclusions and Order:

FINDINGS AND CONCLUSIONS

I. JURISDICTION

The subject matter of this proceeding is properly within the jurisdiction of the Commission by virtue of Minn. Stat. Ch. 237, and was properly before the ALJ by virtue of Minn. Stat. §§ 14.48–14.56 (1982) and Minnesota Rules, part 1400.5100 *et seq.* The hearings held herein were convened pursuant to proper notice. The Commission has fulfilled all relevant substantive and procedural requirements of law and has the authority to now act.

II. NORTHWESTERN BELL TELEPHONE COMPANY

Prior to January 1, 1984, Northwestern Bell Telephone Company was an Iowa Corporation, wholly owned by its parent corporation, American Telephone and Telegraph Company (AT&T), which provided telephone service in Minnesota, North Dakota, South Dakota, Nebraska and Iowa. The 22 Bell Operating Companies, Western Electirc Company, Bell Telephon Laboratories and the Long Lines Department of AT&T were all integrated units of the Bell Telephone System.

When Northwestern Bell's rate application was originally submitted, the Plan of Reorganization filed by AT&T to effectuate divestiture as a consequence of *United States v. American Telephone & Telegraph Co.*, 552 F. Supp. 131 (D.C. 1983), *aff'd* 103 S. Ct. 1240 (1983), had been approved by the Federal District Court; however, divestiture had not yet taken place.

On January 1, 1984, AT&T divested itself of the Bell Operating Companies (BOCs). Ownership of these companies was transferred to seven new Regional Holding Companies (RHCs). The RHCs are autonomous from each other and from AT&T.

Northwestern Bell Telephone Company, Mountain States Telephone and Telegraph Company and Pacific Northwest Bell Tele-

phone Company are subsidiaries of US West, Inc. (US West), one of the seven Regional Holding Companies resulting from the Plan of Reorganization. US West provides service in fourteen states in the Pacific Northwest, Southwest, Rocky Mountains, and Great Plains regions of the country. US West operates several non-regulated subsidiaries. The estimated combined assets of the subsidiaries comprising US West were $17 billion on June 30, 1983, with projected revenues for 1984 of $7.4 billion.

Northwestern Bell is currently a wholly-owned subsidiary, through an intermediate holding company, of US West and provides telephone service in the same territory both in Minnesota and surrounding states as it did prior to divestiture of the Bell Operating System.

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IV. TEST YEAR

In January of 1982, AT&T and the Department of Justice (DOJ) entered into an agreement to settle an antitrust action commenced by the DOJ against AT&T in 1974. In that settlement agreement, AT&T agreed to a massive restructuring of the Bell System. After protracted proceedings, the United States District Court of the District of Columbia (Divestiture Court) formally approved the settlement in the form of a Modification of Final Judgment (MFJ) on August 24, 1983. One of the major requirements of the MFJ was that AT&T submit a detailed Plan of Reorganization (Plan of POR) which was approved as modified on August 5, 1983, by the Divestiture Court.

On January 1, 1984, the Bell Operating Companies (BOCs), including NWB, were divested from AT&T pursuant to the terms of the MFJ and the POR. As a result of divestiture, the License Contract Agreement with AT&T, the Business Information Systems (BIS) Agreement with Bell Labs, and the Standard Supply Contract with Western Electric were terminated. Under the Plan, assets used solely for exchange telecommunications, exchange access functions, and directory functions were assigned to the BOCs. Conversely, the ownership of customer premises equipment (CPE) and assets used solely for interexchange functions was assigned to AT&T. Assets used to provide both exchange and interexchange functions were assigned on the basis of predominant use. With regard to person-

nel transfers between NWB and AT&T, the fundamental principle of the Plan was that employees followed their work.

As a result of divestiture and the MFJ, NWB has been restricted in the scope of its activities and services. NWB may no longer provide interexchange telecommunications services. NWB may only provide exchange service or service within Local Access and Transport Areas (LATAs), provide exchange access for the purpose of originating or terminating interexchange telecommunications (inter-LATA), and provide directory services.

The Company's test year in this proceeding was based on 1983 actual data adjusted as though the Company had operated on a divested basis throughout 1983. The Company utilized a divestiture overlay approach to restate 1983 actual data. NWB projected 1984 investment, revenue, and expense data on both a pre-divestiture and post-divesture basis and determined a relationship between post-divestitute and pre-divestiture data (divestiture ratios). Those divestiture ratios were applied to actual combined 1983 data to determine post-divestiture operations. Estimated 1984 separation factors were then applied to obtain the intrastate post-divestiture test year data. In developing the divestiture ratios, the Company utilized the Divestiture Guidelines jointly prepared by AT&T and the BOCs pursuant to the MFJ and in compliance with the POR as the basis for determining the split of revenues, investment, and expenses between NWB nad the AT&T entities.

The Company has offered to provide to the Commission a specific intrastate accounting of actual 1984 results, indicating the rate of intrastate return actually realized in the first full post-divestiture year, calculated according to the Commission's own findings. The Company has offered to make appropriate refunds to customers to reduce the earned return for 1984 to the authorized level, in the event that the Company earns in excess of the authorized rate of return during 1984 for intrastate operations.

The RUD-AG advocated that the 1983 test year be presented on a pre-divestiture basis claimng that the divestiture effects incorporated into the revenue requirements of the Company are not known and determinable. The RUD-AG charged that the Company and not adequately supported the reliability of its divestiture overlay procedure and that the Company's refund offer should not be accepted as a substitute for proof.

The DPS recognized that an unadjusted actual 1983 test year cannot be considered representative of NWB's future operations in a post-divestiture environment. Consequently, DPS witness Louiselle presented the test year on a post-divestiture basis. His first approach was to use a modified divestiture overlay approach similar to that used by NWB. He also presented an alternative approach which was based on the assumption that the revenues NWB lost upon divestiture were producing earnings at the same rate as all other intrastate revenues. His second alternative approach assumed that the divested revenues were earning at the same rate as all of NWB's interstate services.

The ALJ found it appropriate to reflect the effects of divestiture on NWB stating that to ignore divestiture would be to ignore reality. The ALJ also found that the general divestiture overlay approach was the most reasonable method of accounting for the effects of divestiture and for determining prospective rates for NWB. The ALJ also suggested that the Commission require the Company to provide periodic reports during the time revised rates are in effect and that the Company should be required to refund to ratepayers amounts earned in excess of its authorized rate of return. He noted that the Company had volunteered to do so with respect to 1984.

The ALJ found that 1983 revenues and rate base could be measured as if divested directly without the use of the estimation factors contained in divestiture ratios. He found that calculations relying on a direct divestiture of assets and revenues demonstrated that the divestiture ratios developed by the company with respect to such items tended to understate the Company's revenue requirements. He also found that 1983 expenses could not be divested directly and that it was appropriate to treat investment, revenues, and expenses with a consistent divestiture overlay technique.

Although the ALJ believed that the process by which the Company developed its divestiture ratios involved a large measure of unverifiable subjectivity, he stated that the Company's direct divestiture of 1983 revenues and investment established the fundamental integrity of the overlay process, at least in regard to revenues and rate base. The ALJ stated that the alternative approach suggested by the Department was not the primary recommendation of its expert witness. The ALJ considered the use of a divestiture ratio overlay approach superior to the alternatives presented by both the

DPS and the RUD-AG.

Although the Company generally agreed with the ALJ's findings, it took exception to Findings 52 and 53, which indicated a lack of evidence and documentation as to how Divestiture Guidelines were applied. The Company pointed out that with regard to investments, the updated divestiture ratios were a direct result of the actual asset transfers to AT&T effective January 1, 1984. The Company stated that the itemization of the asset transfers and Company witness Quinn's workpapers that developed the investment overlay percentages based on those transfers are in the record. In rebuttal testimony, Mr. Quinn presented testimony and workpapers showing that a direct divestiture of 1983 revenues indicated that the use of the overlay process for purposes of estimating revenues was conservative in nature. With regard to expenses, witness Yerger testified that the split of expenses was done by each of the operating organizations that were in the best position to apply the Divestiture Guidelines and determine their operational impacts. The split of expenses was accomplished by assessing the job functions that employees were performing and then determining which entity, NWB or AT&T, will perform that job function after divestiture. Job function codes, location codes, and work/time reports were used to help determine the splits.

The Department excepted to the ALJ's adoption of the Company's divestiture overlay approach as "the most reasonable method of accounting for the effects of divestiture." The DPS stated that there was no way to determine the accuracy of the Company's portrayal of post-divestiture expenses until after December 31, 1984. Thus, the DPS contended that it is impossible to state whether the Company's divestiture overlay approach understates or overstates its revenue requirement. The DPS argued that its alternative approaches are no more subjective or verifiable than the Company's overlay approach but are equally defensible.

The RUD-AG decided not to except to ALJ's rejection of its position. The RUD-AG stated that the ALJ's acceptance of divestiture ratios in a disaggregated form as adjusted by the DPS and his acceptance of various adjustments proposed by the DPS and RUD-AG resulted in a reasonable approach to this unique and complex issue.

The Commission is in general agreement with the findings,

rationale, and recommendations of the ALJ that the effects of divestiture should be recognized in this proceeding and that a divestiture ratio overlay approach should be utilized to measure the divestiture effects. The Commission agrees that the Company's direct divestiture of 1983 revenues and investment, as indicated in its rebuttal testimony, substantiated the reliability of the overlay process as it relates to revenues and rate base.

The Commission also agrees that the Department's alternative approach was not the primary method sponsored by its expert witness. Very few pages of Mr. Louiselle's supplemental and surrebuttal testimony relate to his two alternative approaches. The revenue loss in his alternative approach was based on a comparison of 1983 intrastate revenue on a pre-divestiture and post-divestiture basis. The post-divestiture revenue used in that comparison was the final revenue number calculated by Mr. Louiselle in his divestiture overlay approach after *pro forma* adjustments. Thus, the divestiture overlay process was utilized to determine the revenue loss in the DPS alternative approach. The Commission believes that the rate base after divestiture can more accurately be determined by use of an overlay approach that is based on the actual asset transfer that occured than by arbitrarily calculating the divested rate base as a function of revenue loss.

The Commission concludes, as did the ALJ, that the use of the divestiture ratio overlay approach to account for the effects of divestiture is superior to the alternatives presented by both the DPS and the RUD-AG. The Commission will determine whether to use aggregated or disaggregated divestiture ratios as it considers rate base, revenues, and expenses.

The ALJ recommended that the Commission require the Company to report on a periodic basis its activities during the period of time within which the revised rates remain in effect as a check against the accuracy of the divestiture ratios used in this proceeding. He further recommended that the Commission should require the Company to refund or credit to ratepayers amounts earned in excess of its authorized rate of return. This recommendation was prompted, in part, by NWB's voluntarily offering to make such refunds or credits with respect to 1984.

While the Commission would encourage the Company's voluntary efforts to refund rates that are shown to be excessive when

the haze of divestiture is removed and the actual results are known, the Commission has given little weight to such a refunding proposal since there is no way to enforce such a proposal. Final rates determined as a result of this case are just that—final rates. As the Commission has recently noted in *Continental Telephone Company*, Docket No. P-407/GR-83-294 (May 14, 1984), p. 2:

> Rate making proceedings have reasonably finite time limits. Indefinite and unknown contingencies should not cloud the Commission's determination of this issue [interest imputed to JDIC portion of rate base] in this case. The Commission also finds that RUD has not shown that Minn. Stat. § 237.075 (1983) provides the Commission authority to make final approved rates subject to refund as proposed by the RUD.

Once final rates are established, the Commission recognizes that it could lower those rates only prospectively after affording the Company the opportunity for hearing. While the Commission encourages the Company to follow through with its undertaking to refund, its decision on this issue has been made upon the record before it and is not based upon the refunding offer.

However, the Commission concludes that the Company should be required to file intrastate financial results each quarter on a calendar year to date basis and for the 12 month period ending each quarter. The reports should continue as long as the rates established in this proceeding remain in effect.

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2. Capital Structure and Cost of Debt

Mr. Bauhard

Mr. Bauhard initially recommended that the Commission adopt NWB's projected post-divestiture capital structure as of 1/1/84. He felt that NWB's capital structure had become the most appropriate means to determine the overall fair rate of return in this proceeding because he no longer relied on AT&T's cost of equity to estimate NWB's cost of equity. This recommendation was a change from the recommendation he made in NWB's previous rate case, *NWB*, Docket No. P-421/GR-82-203, where he recommended that

the Commission use the Bell System consolidated capital structure. He felt that the focus on NWB rather than AT&T recognized the effects of divestiture.

Mr. Bauhard began the determination of his recommended capital structure for NWB by first taking the capital structure for NWB at 12/31/83 which consisted of $1.259 billion long term debt, approximately $53 million short term debt and approximately $2.273 billion common equity for a total of $3.585 billion capital. This resulted in a capital structure for NWB at 12/31/83 of approximately 36.6% debt and 63.4% equity.

To determine a projected actual capital structure for NWB as of January 1, 1984, Mr. Bauhard estimated that NWB, at divestitue, would transfer approximately $441 million of its equity to AT&T. The Company would also require additional short term debt financing of approximately $27 million on January 1, 1984. This combined with the $53 million in short term debt as of 12/31/84 would result in about $80 million in short term debt financing for NWB as of 1/1/84. If Mr. Bauhard's estimates were correct, NWB would have $1.832 billion equity and $1.339 billion debt as of January 1, 1984. The resulting debt to equity ratio would be 42.2% debt and 57.8% equity. Mr. Bauhard argued that this capital structure would barely meet the standards for the Triple A debt rating NWB enjoyed prior to the divestiture.

In his written rebuttal testimony, Mr. Bauhard updated his recommendation for NWB's capital structure to reflect the fact that NWB transferred approximately $23 million in equity to US West for directory advertising on January 3, 1984. This transfer was financed with $23 million in short term debt. As his final recommendation, Mr. Bauhard urged the Commission to adopt NWB's actual capital structure as of January 3 1984 which contained 43.6% debt and 56.4% equity.

During his oral rebuttal testimony, Mr. Bauhard mentioned that NWB planned to issue $150 million in long term debt in March 1984. The Company did not recommend any changes in its proposed actual capital structure to reflet the issuance of this debt.

NWB originally projected an embedded cost of debt for NWB of 7.8% as of January 1, 1984. This cost of debt figure was updated to 7.93% in Mr Bauhard's rebuttal testimony to correspond with NWB's actual capital structure as of January 3, 1984. In oral

rebuttal testimony, Mr. Bauhard mentioned a planned long-term debt issue of $150 million by NWB at an interest rate in the range of 13.50% to 13.25%; he claimed the debt issue would raise NWB's embedded cost of debt ot 8.5%. In oral testimony, Dr. Litzenberger stated that NWB issued the $150 million debt at a cost of 13.69% in March 1984. In its brief, NWB recommended using an 8.5% embedded cost of debt.

Mr. Meyer

Mr. Meyer described the financial policies and results necessary for NWB and its parent, US West, to maintain access to the long term credit markets and the quity markets on reasonable terms.

Mr. Meyer examined the coverage ratio and capital structure requirements on long term bond investments as indicated by bond rating agencies. He measured the advantages and disadvantages of various bond ratings to NWB both in terms of cost to the ratepayer and financial flexibility to the Company. In addition, he discussed the importance of stock price to the financibility of US West and its operating companies and, in turn the importance of earning a rate of return on equity and utilizing a dividend policy which would enable US West to achieve net proceeds of not less than book value when issuing new common stock.

Mr. Meyer presented the minimum financial requirements of companies necessary to maintain credit ratings at various levels as stated by Standard & Poor's and as followed by Duff and Phelps, and Moody's.

Mr. Meyer felt that it was essential for NWB to maintain a capital structure consistent with triple A and double A ratings to raise additional increments of debt capital in the future.

Mr. Meyer also felt that it was critical that US West adopt a dividend policy necessary to provide a market-to-book ratio of at least 120% and hopefully more. To do this Mr. Meyer felt that it was necessary to have a dividend-to-book ratio of 10.25% to 10.50% and a payout ratio of 66-2/3%. He felt that this dividend policy combined with investor expectations of a growth rate in earning per share of 6.9% to 8.6% per annum should produce a minimum market-to-book ratio of 120%.

In the future, if US West engaged successfully in non-regulated business, Mr. Meyer felt that there should be the opportunity to

enhance the market-to-book ratio of the Company, thereby lowering the cost of capital. If the Company was able to issue its new common stock at net proceeds above book value, then the growth rate necessary to attract investors was enhanced and the rate of return on equity necessary to achieve competitive total return declined.

Mr. Meyer argued that if the Commission adopted Dr. Thompson's hypthetitcal capital structure, and then it was subsequently adopted by the Company, the Company's bond rating would be, in all probability, downgraded. As a result, the cost of capital would increase and the availability of new capital would decrease.

Dr. Thompson

Dr. Thompson recommended that a hypothetical capital structure be used for NWB which consisted of 42.2% debt, 7.8% imputed debt, and 50.0% common equity.

Dr. Thompson argued that the reasonableness of a capital structure for regulatory purposes must be based upon objective benchmarks. He felt that a useful benchmark was an average capital structure for a group of comparable companies.

Dr. Thompson felt that the determination of the actual capital structure of a company was the prerogative of management. However, for regulatory purposes, he argued that it was the Commission which must decide what capital structure is fair and reasonable to use in determining the overall allowed rate of return to be earned on the utility's rate base. Dr. Thompson felt that the determination of a operational capital structure from an accounting perspective for a utility as a subsidiary of a diversified company was primarily a decision for company management, but where it was appropriate and necessary, the Commission could impose or impute a capital structure different from a company-proposed capital structure when it was reasonable to conclude that the proposed capital structure was inappropriate for regulatory purposes.

Dr. Thompson argued that the determination of that capital structure should be made using references to industry comparisons based upon risk relationships and industry averages to determine appropriate benchmarks. Although the Company management had the responsibility of establishing an operational capital structure for a subsidiary, the reasonableness and safety of that imputed capital

structure for regulatory purposes rested with the Commission.

Dr. Thompson based his imputed or hypothetical capital structure upon a review of several comparable groups. He considered this a reasonable balance between investors' and consumers' interests. He started with NWB's projected capital structure on 1/1/84 and compared its projected common equity ratio (57.8%) with common equity ratios of comparable groups.

One of his comparable groups consisted of the companies used by Dr. Amit in his cost of common equity analyses. A second and third group were selected based on the testimony of Mr. Bauhard and Mr. Morris, and two additional groups were those used by Dr. Litzenberger. Dr. Thompson also looked at the capital structure used in the last NWB rate cae which contained 50.1% common equity.

Dr. Thompson determined his recommended 50% equity ratio by looking at the most recent common equity ratios for the comparable groups. The common equity ratios for these companies ranged from a high of 61.69% (Cincinnati Bell) to aq low of 33.54% (Mid-Continent). For a AA regulated company he felt that a 50% equity ratio was appropriatge for ratemaking purposes.

Dr. Thompson treated the difference between his proposed 50% equity ratio and the company proposed 57.8% equity ratio as a separate type of capital and assigned to it a current average cost of AA rated debt. AA was the current rating of NWB and was similar to ratings for comparable groups of companies.

Based on his analysis and regulatory considerations, he believed that his recommended capital structure was a reasonable estimate for NWB Minnesota's capital structure for regulatory purposes during the current regulatory period.

With regard to the cost of debt, Dr. Thompson felt that 7.8% was a reasonable estimate for the average embedded costs of long term debt for NWB during the current regulatory period. He felt it was consistent with the use of his proposed capital structure. In addition, he believed that the current cost of debt of 12.8% (average from November 1982 to October 1983) contained in Moody's November 1983 bond record for a AA rated utility was a reasonable estimate for regulatory purposes for the excess portion of the common equity he proposed be treated as a separate form of debt (imputed debt.)

Dr. Thompson recommended an overall rate of return for NWB of 11.51% using the 7.8% return on long term debt, 12.8% return on imputed debt and 14.46% on common equity.

In its Proposed Findings of Fact and Conclusions of Law, the DPS revised Dr. Thompson's recommendations to reflect updated numbers. The DPS's final recommendation consisted of 43.6% debt (at an 8.5% cost, increased from the previous 7.93% to reflect the issuance of $150 million in long term debt), 6.4% imputed debt (at a 12.83% cost) and 50% equity (at a 14.46% cost) for an overall cost of capital of 11.76%.

Dr. Marcus

Dr. Marcus testified that the appropriate capital structure should match the entity on which the cost of equity is being based. In this proceeding, he recommended the use of US West on which to base the cost of equity and therefore argued that US West's consolidated capital structure should be used to determine NWB's overall rate of return. US West's consolidated capital structure as of 1/3/84 contained 44.06% debt and 55.94% equity. According to the Company, this capital structure reflected only the consolidated operations of US West's regulated entities, which included NWB, Pacific Northwest Bell, and Mountain States.

Prior to market data being available on US West, Dr. Marcus initially recommended a capital structure containing 45% debt and 55% equity. He employed several guidelines to determine his appropriate capital structure for NWB. These were (1) the capital structures employed by other utilities, (2) the capital structure trends for the Bell System, and (3) the capital structure standards set forth in the Consent Decree.

To observe the capital structure employed by other utilities, Dr. Marcus considered all Aa-rated electric utilities. These utilities averaged a 39.8% common equity ratio. He also considered the common equity ratios of non-Bell telephone utilities. Their average equity ratio was 52.5%. He also reported the financial statistics for another group of telephone companies with significant non-telephone sources of revenues and noted that the average common equity ratio for the group was only 41.7% but that their bond rating was generally weaker (Baa). Finally, he noted that the trend in AT&T's capital structure was of interest.

It was apparent to Dr. Marcus that the Bell System's common equity ratio had been quite stable at about 50% from 1978 through 1980, but had since displayed a sharp increase. Dr. Marcus stated that AT&T's 1982 common equity ratio of 55.6% already represented a rise of 500 basis points in just two years. He said this increase had been justified by AT&T citing the rise in competitive risks.

His initial conclusion that the Commission base its authorized overall rate of return on a capital structure containing 55% common equity and 45% debt was based on the following considerations:

1. NWB's proposed capital structure with 57.8% equity and 42.2% debt was a projection. The actual ratio upon divestiture might differ depending on the actual amount of assets transferred to AT&T.
2. A 55% equity level was significantly higher than the common equity ratio of high grade electric utilities (Aa bond rating).
3. A 55% equity ratio was consistent or higher than the capital structure of non-Bell telephone companies.
4. The 55%–45% mix already reflected the enormous rise in the Bell System's common equity accomplished between 1980 and 1982.
5. The 55%–45% mix was the standard set in the Consent Decree.
6. US West was a new business entity for which no direct risk measures were yet available. A decision to authorize a higher Ratio than 55% should be made only based on explicit evidence.

In its Proposed Findings of Fact and Conclusions of Law, the RUD-AG presented its final recommendation as to the appropriate capital structure for NWB and the resulting overall rate of return. The RUD-AG argued that the evidence in this case supported an overall rate of return of 11.60% based on a capital structure containing 44.06% debt and 55.94% common equity, with the cost of debt being 7.93% and the rate of return on equity capital being 14.5%.

This final recommendation was a result of Dr. Marcus' further testimony that US West's consolidated capital structure should be used as the appropriate capital structure for NWB.

With regard to the cost of debt, Dr. Marcus agreed with Mr. Bauhard's initial updated recommendation of 7.93% as the actual

embedded cost of debt for NWB. The RUD-AG did not subsequently accept, however, NWB's revised cost of debt of 8.5%, arguing that it was not adequately supported by record evidence. The RUD-AG argued that NWB's proposed embeded cost of debt of 8.5% should be rejected by the Commission, because it was unclear what the cost of the March debt issue was to NWB and what effect the issue had on NWB's embedded cost of debt. The RUD-AG contended that if the Commission were to take the debt issue into account, then the proposed capital structure must be revised to reflect the addition of the new debt.

The Administrative Law Judge

The ALJ found that NWB did not sustain the burden of proof that the actual capital structure of the Company was appropriate for regulatory purposes. Based on this finding, he determined it was appropriate to attribute to NWB a hypothetical capital structure based on objective tests of propriety.

To determine his hypotheticial capital structure, the ALJ took into consideration several different observations on regulated companies' equity ratios. He determined an average equity ratio of 45.65% for five groups of companeis selected by the parties as comparable to NWB and found that figure provided an objective benchmark in judging the capital structure to be assigned to NWB for regulatory purposes. He also determined that the weighted average authorized common equity ratio for regulatory purposes of US West's regulated telephone operations was 51.58%. He found as a consequence of his considerations that it was appropriate to retain the common equity ratio of 50.1% authorized in the NWB's last general rate case. The ALJ determined that the appropriate hypothetical capital structure contained 50.1% common equity and 43.6% debt, and 6.3% additional debt.

The ALJ recommended that the embedded cost of debt was 8.5%. This reflected the addition of a $150 million debenture issue at a cost of 13.69% during the week of March 18, 1984. He assigned the latest 12 month average cost of debt, 12.83%, to the 6.3% imputed debt he included in the Company's capital structure.

The ALJ recommended that the Commission authorize an overall rate of return for NWB of 11.76% based on a capital structure

that included 50.1% equity (at a 14.46% cost), 43.6% debt (at a 8.5% cost), and 6.3% imputed debt (at a 12.83% cost).

C. Commission Findings and Conclusions.

Introduction

In this proceeding, the Commission was presented with a difficult task regarding the determination of a fair and reasonable rate of return on equity for NWB, the selection of an appropriate capital structure and the determination of the cost of NWB's debt in a post-divestiture environment. In the past, the Commission has determined the capital structure and rate of return for AT&T and applied the results to NWB, which prior to divestiture was a wholly-owned subsidiary of AT&T. The Commission finds that, because of the divestiture, it is no longer reasonable to use AT&T as a proxy for NWB.

The difficulty of the task of determining an appropriate rate of return was exacerbated by the lack of reliable evidence in the post divestiture period in terms of the evidence's substance and historical perspective upon which the Commission could base its decisions. The transfers of equity to AT&T, a consequence of divestiture, the transfer of equity to US West, a post-divestiture transaction to reflect the transfer of the Yellow Pages advertising operation and telephone directory operations, and the issuance of debt to finance such transfers further confused and complicated the record because no concrete data was presented by the Company regarding such transfers.

NWB does not issue common stock to the public; its common stock is all held by its parent company, US West. The Commission agrees with the ALJ that there is insufficient historical and market data available on the equity of US West and the other regional holding companies to justify placing primary reliance on a DCF analysis of these entities to determine a fair and reasonable rate of return for NWB in this proceeding. Therefore, an appropriate proxy group of companies must be used. Commission will rely upon the DCF analysis of comparable-risk telephone companies performed by DPS witness Amit as the primary method for determining the return on equity to be allowed NWB.

The Commission also agrees with the ALJ that neither the post-divestiture capital structure of NWB nor that of US West is appro-

priate for regulatory purposes in this proceeding. Therefore, the Commission must impute an appropriate capital structure for rate-making purposes. The Commission will rely primarily on the analysis DPS witness Thompson, as modified slightly by the ALJ, to make this determination.

The Commission will adopt the ALJ's conclusions that a reasonable rate of return on equity for NWB is 14.46%; that the appropriate capital structure for determining the overall cost of capital consists of a common equity ratio of 50.1%, embedded debt of 43.6%, and imputed debt of 6.3%; and that the appropriate cost of the imputed debt is 12.83%. The Commission will use a cost of embedded debt of 8.22%, rather than the 8.50% employed by the ALJ, because the 8.50% is not adequately supported in the record. The resulting Commission-allowed overall return for NWB is 11.63%.

The Commission will discuss below in more detail its findings and conclusions with respect to NWB's cost of equity, the appropriate capital structure to utilize in determining the overall rate of return to NWB and the cost of debt.

Return on Common Equity

As an administrative agency, the Commision must act both within the scope of its enabling legislation and the strictures of reviewing judicial bodies. Two United States Supreme Court cases provide these general guidelines for Commission rate of return decisions:

1. The allowed rate of return should be comparable to that generally being made on investments and other business undertakings which are attended by corresponding risks and uncertainties.

2. The return should be sufficient to enable the utility to maintain its financial integrity.

3. The return should be sufficient to attract new capital on reasonable terms.

Bluefield Water Works & Improvement Co. v. P.S.C., 262 U.S. 679 (1923), *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

No particular method or approach for determining a rate of return was mandated by those cases, but the necessity of a fair and reasonable rate of return was clearly stated:

> Rates which are not sufficient to yield a reasonable

> return on the value of the property used, at the time it is being used to render the service, are unjust, unreasonable, and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment. *Bluefield Water Works*, 262 U.S. at 690.

The Minnesota Supreme Court's latest decision on rate of return was stated in *Minnesota Power & Light Company v. Minnesota Public Service Commission*, 302 N.W.2d 5 (Minn. 1980). The Court stated:

> . . . The single term "ratemaking" has been used to describe what is really two separate functions — (1) the establishment of a rate of return, which is a quasi-judicial function, and (2) the allocation of rates among classes of utility customers, which is a quasi-legislative function.
>
> . . . we now hold that the establishment of a rate of return involves a factual determination which the court will review under the substantial evidence standard.

302 N.W.2d at 9.

In conducting its evaluation of the Commission's decision, the Court explained:

> . . . A reviewing court cannot intelligently pass judgement on the PSC's determination unless it knows the factual basis underlying the PSC's determination. Judicial deference to the agency's expertise is not a substitute for an analysis which enables the court to understand the PSC's ruling. Henceforth, we deem it necessary that the PSC set forth factual support for its conclusion. The PSC must state the facts it relies on with a reasonable degree of specificity to provide an adequate basis for judicial review. We do not require great detail but too little will not suffice.

302 N.W.2d at 12.

In order to provide the factual basis for its decision required by the Court, the Commission has reviewed the testimony of each of the parties on rate of return on common equity, the objections raised thereto by other parties and the recommendation of the ALJ. Based on that review, the Commission makes the following findings with regard to a fair rate of return for NWB's common equity:

All witnesses testifying to the rate of return on common equity utilized the DCF method as their primary method. The Commission finds that the DCF method is the appropriate method for estimating NWB's cost of equity. This method is a market-oriented, opportunity cost approach which views the relationship between the cost of equity, investor's income expectations and market price in a theoretically sound and systematic manner. Using the DCF method, an analyst may infer the rate of return investors implicity require of a particular equity investment. Under the DCF theory, the return expected by investors is the sum of the expected dividend yield of the stock and the expected growth in dividends.

NWB does not issue common stock to the public. All of its common stock is ultimately held by a parent company, formerly AT&T and now US West. It is, therefore, impossible to use a market based method of analysis to determine a cost of equity directly for NWB in general or for its Minnesota operations in particular. As a result a proxy must be used to determine a fair cost of equity capital for NWB. Previous determinations of the cost of equity capital for NWB have relied primarily upon a DCF analysis of its then parent, AT&T, adjusted for differing business risks. The Commisison finds that, as a result of divestiture, it is no longer appropriate to use AT&T adjusted for differing business risks. The Commission finds that, as a result of divestiture, it is no longer appropriate to use AT&T as the primary proxy for determining the return on equity to be allowed NWB. AT&T and NWB may not be risk-comparable since AT&T will be involved mainly in the long-distance market and non-regulated business activities, while NWB's activities will be primarily in regulated local service and exchange access service.

NWB placed primary reliance on a DCF analysis of US West and the RUD-AG relied mainly on an analysis of all the regional holding companies. In theory, US West may be a good proxy for

NWB, since it is the parent company of NWB and is the entity through which shareholders may own stock; the other regional holding companies may also be reasonable proxies, since they should be attended by similar business risks as US West. However, the Commission agrees with the DPS and the ALJ that there is insufficient historical and market data available for US West and the other regional holding companies in this record to allow placing primary reliance on such data for determining the cost of equity for NWB in this proceeding.

Trading in the stock of the regional holding companies began on a "when-issued" basis only on November 21, 1983 and regular trading did not start until mid-February, 1984. These companies have not declared or paid dividends; Dr. Litzenberg and Dr. Marcus had to rely on estimates of 1984 dividend from AT&T's November 1983 Information Statement and Prospectus in their DCF analyses. In addition to the lack of dividend and stock price history for the regional holding companies, the irregularities and uncertainties accompanying the market trading of US West stock to date identified by Dr. Litzenberger and Mr. Morris during cross-examination show that US West data is not a reliable basis for estimating NWB's cost of equity. These market trading uncertainties include substantial jumps in stock prices from one day to the next due to large blocks of stock changing hands and margin requirements imposed upon institutional investors by the New York Stock Exchagne. Hence, the Commission finds that primary reliance should not be placed on the limited market data available for US West and other regional holding companies in a DCF analysis for determining the cost of equity to NWB. Therefore, some other more appropriate proxy must be used.

The Commission finds, as did the ALJ, that the appropriate proxy group to use in the DCF analysis is the comparable telephone group used by DPS witness Amit. This group consisted of Cincinnati Bell, Mid-Continent Telephone (subsequently AllTell), Rochester Telephone, and Southern New England Bell. Dr. Amit insured that the proxy group was fairly selected by starting with all companies listed in the Value Line Investment Survey which are classified by the Standard Industrial Classification as primarily engaged in furnishing telephone service and then eliminating companies with more than 20% non-telephone revenue; companies

whose primary business is long distance, rather than local service; and AT&T which, at the time of the original analysis, was not yet primarily a long distance company. The Commission finds that this proxy group is risk-comparable to NWB, based on type of business activity and objective risk measures.

The Commission also agrees with the ALJ that the result of the DCF analysis of Dr. Amit, using the comparable group described above, provides an appropriate and reasonable estimate of the rate of return on equity for NWB. Dr. Amit's analysis developed a dividend yield of 7.70% and a growth rate of 6.76%, resulting in a cost of equity of 14.46%. The reasonableness of this result is confirmed by several other DCF analyses.

Dr. Amit examined the yields of his comparable group companies for the four quarters of 1983. He used the average of the yields for the last two quarters of 1983 for each of the companies, adjusted for expected dividend growth, to derive his average dividend yield of 7.70%. The Commission finds the period used to calculate this dividend yield provides a reasonable estimate of the current yield period, without being so short as to be strongly affected by possible short-term aberrations in the capital markets.

Dr. Amit thoroughly analyzed the expected growth rates for each of the four companies in his comparable group. He examined the five and ten year growth rates in earnings, dividends, and book value per share, using both log-linear and compound (Value Line) growth rates, as well as internal growth rates. He concluded that the following growth rates were appropriate: Cincinnati Bell, 6.71%; Mid-Continent, 6.58%; Rochester, 7.10%; and Southern New England, 6.65%. The average growth rate was 6.76%. The Commission finds that Dr. Amit's growth rate analysis properly examined the major financial and economic variables affecting expected future growth for his proxy companies, and provides the most reasonable estimate of the growth rate likely to be expected by investors.

Based on Dr. Amit's analysis, the Commission concludes, as did the ALJ that the fair and reasonable cost of common equity to NWB is 14.46%. The Commission finds a 14.46% rate of return allowance will allow the Company to maintain its financial integrity and attract new capital on reasonable terms.

The Commission finds that no adjustment to the cost of equity allowance for market breaks, market pressure, or issuance costs is

necessary or appropriate in this proceeding. It would be highly inappropriate to increase the equity return allowance to provide a cushion to investors for possible declines in general market conditions (market breaks), since the risk of market fluctuations is inherent in all equity investments and thus already reflected in the return required by investors measured in the DCF method. The Commission agrees with the DPS, RUD-AG, and ALJ that no adjustment for market pressure or issuance costs is reasonable in this proceeding because US West has no plans for general public issuance of common stock. According to AT&T's Information Statement and Prospectus, US West's capital requirements will be met through debt issues and existing stock plans.

As discussed previously, the lack of adequate market trading data precludes placing primary reliance on US West or the other regional holding companies as proxies for NWB; however, such an analysis, if properly conducted, could provide a secondary check on the previously accepted anlysis. The Commission finds that the results of Dr. Marcus' reasonableness of the 14.46% cost of equity for NWB.

Dr. Marcus used the most representative and reliable data which does exist for the regional holding companies to derive his cost of equity estimate of 14.50%. the results for the regional holding companies as a group used by Dr. Marcus, rather than the results for US West alone, are less prone to be influenced by error and market imperfections that may occur for any one particular company.

Another broad check on the primary DCF results is provided by Dr. Amit's DCF analysis of 19 electric companies and 83 gas and electric utilities. The Commission finds that the 14.15% and 14.25% costs of equity for these groups, respectively, confirms the reasonableness of a 14.46% return on equity for NWB. Gas and electric utilities have generally had a cost of equity capital somewhat below that of telephone companies due to perceived risk differences.

Based on the above discussion, the Commission concludes that a 14.46% rate of return on equity for NWB in this proceeding is appropriate. The Commission will next further discuss its reasons for not relying on the other rate of return analyses presented.

Dr. Litzenberger, in his supplemental testimony, presented a DCF analysis on US West. The Commission rejects his analysis because

it was based primarily on US West alone and the analysis itself was flawed. The Commission has acknowledged that the data on the Bell regional holding companies is limited. Because of the lack of historical perspective, particular abberations associated with US West are likely to be heightened.

Another flaw in Dr. Litzenberger's DCF testimony was his reliance on security analysts' forecasts to determine an expected growth rate. The Commission has consistently rejected the use of analysts' forecasts as an appropriate method for determining the growth rate as in *NWB*, P-421/GR-82-203. Investment reports frequently offer differing dividend and earnings growth rates, and employ different periods of observation. The methodology underlying their estimates and the use which the analysts make of their estimates are also not uniform. Finally, Dr. Litzenberger did not provide any evidence that the analysts he cited are representative of the universe of analyst reports relied upon by investors.

Mr. Morris' DCF analysis leaves the Commission as bewildered as the ALJ as to how Mr. Morris determined his growth estimate. His recommendation was based heavily upon projections from various sources for growth in the general economy and in the firms which made up his composit group, without accompanying evidence in the record regarding the source of such projections or the viability of the assumptions contained in them. This reason alone would be sufficient for the Commission to reject Mr. Morris' DCF analysis. In addition, Mr. Morris, like Dr. Litzenberger and Mr. Bauhard, used an unreasonably short period for measuring his dividend yield, which was not reflective of the yield likely to be expected by investors for the regulatory period.

The DCF analysis of Mr. Bauhard is rejected in part because of his inappropriate use of analysts' forecasts for his DCF growth component, for the same reasons discussed by the Commission with respect to Dr. Litzenberger's testimony. In addition, the group of electric utilities used by Mr. Bauhard is not sufficiently risk-comparable to NWB to be relied upon as a primary proxy for NWB.

The Commission rejects Dr. Smith's DCF analysis. The Commission can not rely on Dr. Smith's individual growth rate estimates for the companies in his comparable group because, as Dr. Smith acknowledged in his oral testimony, the individual estimates could

not be considered appropriate for each of the respective companies. The Commission agrees with the ALJ that the large variations in Dr. Smith's individual growth estimates make the results produced by averaging unreliable, and greatly influenced by the composition of the group.

Mr. Morris and Dr. Litzenberger also relied on variations of the risk premium method as secondary methods of analysis. The two main difficulties with the application of a risk premium approach are the need to find firms of comparable risk to the utility in question and the need for a quantifiable and reasonably stable risk premium. The Commission finds that the analyses of Dr. Litzenberger and Mr. Morris do not provide reliable guides to NWB's cost of equity.

Mr. Morris utilized a conventional risk premium analysis. This method attempts to measure the additional return required by investors in common stock compared to investors in government bonds. The Commission finds that Mr. Morris did not overcome the difficulties associated with the use of the risk premium analysis. He did not demonstrate that the average market risk premium was reasonably stable. The Commission is convinced after reviewing Dr. Amit's exhibit showing various expected risk premiums that the determination of a risk premium value varies depending upon which riskless asset is used to compare with stock returns. Dr. Amit's exhibit also demonstrated that the value of the risk premium is not stable over the years and can vary by as much as 8 percentage points (the risk premiums observed between the years 1951 and 1981 based on U.S. Bonds, A-rated industrials, AAA-rated industrial and AAA composite).

Dr. Litzenberger used a form of the capital asset pricing model (CAPM), which he characterized as a variant of the risk premium approach. The Commission finds that the CAPM exhibits some of the same shortcomings as the traditional risk premium approach in tht the market risk premium is quite volatile and the yield on Treasury Bills or bonds is also subject to rapid change. For example, Dr. Litzenberger's original cost of equity estimate using the CAPM ws 17.7% (a combination of the 12.1% yield to maturity on government debt reported on August 8, 1983 and an estimated risk premium of 5.6%). His updated cost of equity estimate four months later was 17.1% utilizing the same CAPM method and the

5.6% risk premium. The yield on the riskless asset, twenty year government debt, had dropped to 11.8% (as reported on January 17, 1984).

The Commission finds the results of the CAPM and risk premium analyses in this record to be unreliable as guides for determining the appropriate return on equity for NWB.

Capital Structure

The selection of a capital structure is a major element in the determination of rates and slight variations in the capital structure adopted for regulatory purposes may have significant impacts on a Company's revenue requirements. The capital structure is a financial concept which represents the sources of capital to the Company. Conceptually, the problem for the Commission is to identify what the two major sources of capital, debt and equity, are appropriate for ratemaking purposes, to the best interests of the Company and its ratepayers.

The Commission is charged with determining the most reasonable capital structure for NWB for ratemaking purposes. The Commission's ultimate obligation is to set fair and reasonable rates. To accomplish this, ratepayers can only be charged rates based on a reasonable capital structure. In making that determination, the Commission must balance the needs of ratepayers for economy and investors for safety. The effective cost of debt to a company is substantially lower than its cost of equity because the interest rates required by debt-holders are generally less than the return required by stockholders and because interest expense is tax deductible. Beyond some point, increases in the debt ration may lead to increased financial risk for the company. Within reasonable bounds, however, the higher the proportion of debt in the capital structure (and, correspondingly, the lower the proportion of equity), the lower the overall cost of capital is to ratepayers.

NWB has the burden of demonstrating by competent evidence that the capital structure it proposes is reasonable and appropriate. Minn. Stat. § 237.075, subd. 4 (1983 Supp.). The Commission agrees with the ALJ that the Company has mischaracterized its burden of proof in this proceeding. NWB asserts that it does not have the burden of proving that its capital structure is reasonable and prudent. Rahter, NWB contends that the intervenors must

show, and the Commission must find, the Company's actual capital structure to be unreasonable and imprudent before a hypothetical capital structure may be imputed for ratemaking purposes. The Company relies in large part on the court decision in *Northwestern Bell Telephone Company v. State*, 299 Minn. 1,216 N.W. 2d 841 (1974). The Commission disagrees with the Company's assertions and finds that *NWB v. State* does not create a substantial presumption in favor of the capital structure proposed by the Company.

The Commission addressed this issue in its decision in *Central Telephone Company*, Docket No. P-405/GR-83-300 (March 30, 1984) at 26, wherein it stated:

> The Company has the ultimate burden of proving that the capital structure it proposes is appropriate and reasonable. Minn. Stat. § 237.075, Subd. 4 (1982). The Commission establishes the following procedure for determining the appropriate capital structure:
>
> 1. The Company has the burden of coming forward and establishing by competent evidence a proposed capital structure.
> 2. A rebuttable presumption arises that the Company's proposed capital structure is reasonable and appropriate.
> 3. Other parties have the burden of going forward with evidence to rebut or meet the presumption that the proposed capital structure is appropriate. This burden does not shift to other parties the Company's burden of proof.
> 4. The risk of nonpersuasion or ultimate burden of proof remains with the Company. Therefore the Company must meet or rebut contrary evidence or the presumption of appropriateness of the Company's proposed capital structure ceases to exist.

NWB argued that applying the above procedure would be a substantive departure from *NWB v. State*. The Commission disagrees.

In its May 31, 1984 Order denying Reconsideration in *Central*, P-405/GR-83-300, the Commission made it clear that "the procedure is a mechanism used for the purpose of establishing which

party has responsibility for going forward with the evidence." The Commission further stated that the procedure was derived from Rule 301 of the Minnesota Rules of Evidence regarding evidentiary presumptions. The Commission viewed the four-step procedure as not varying or changing the manner in which it selected the most appropriate capital structure for ratemaking purposes.

In a typical general rate case the Commission will receive several proposals regarding the appropriate return on equity and capital structure. The Commission does not engage in a mechanical analysis when it evaluates these proposals as may be suggested by the four-step procedure. The Commission must sift through the evidence supporting these proposals to determine which is the most reasonable for ratemaking purposes. To arrive at a reasonable result the Commission may adopt one of the proposals or parts of several proposals. Flexibility is essential to the Commission's evaluation of capital structure and return on equity. Any interpretation of the four-step procedure which limits the Commission's flexibility is in error.

The Commission did not intend to create by the four-step procedure a substantive or legal presumption in favor of a company-proposed capital structure. A substantive presumption would unnecessarily restrict the Commission's flexibility and place primary focus on only one of the proposals. In addition, a substantive presumption would be inconsistent with the requirements of Minn. Stat. § 237.075, subd. 4 (1982) which places the burden of proving the reasonableness of a proposed change in rates upon the telephone company.

Therefore, the Commission finds this procedure does not make the substantive changes which the Company claims. The Commission hereby rejects the Company's arguments on this issue. To carry out its statutory duty to determine the most reasonable capital structure for ratemaking purposes, the Commission must consider all the proposals and evidence in the record.

In this regard the Commisison views NWB's claim regarding the legal impact of *Northwestern Bell Telephone Company v. State*, 299 Minn. 1, 216 N.W.2d 841 (1974) as an erroneous reading of that Court's decision. The Commission does not believe that the Supreme Court in *NWB v. State* established as a matter of law that the Commission must first determine that the company-

proposed capital structure is unreasonable before it evaluates or selects an alternative proposal. In that decision the Court conducted its review on the basis of the record before it. That record did not contain competing capital structure proposals. On the basis of that record the court determined that the Commission's decision approving the company's proposed capital structure was supported by evidence contained in the record.

Previous Commission decisions, including *Northwestern Bell Telephone Company,* Docket No. P-421/GR-82-2003 (April 10, 1983) and *United Telephone Company,* Docket No. P-430/GR-82-200 (April 27, 1983) in so far as they may be interpreted to suggest that there must be a finding of unreasonableness of a company's proposed structure before an alternative is entertained, are clarified by this Order. In order for the Commission to determine the most reasonable capital structure for ratemaking purposes, the Commission must have the flexibility to examine all proposals. Requiring the Commission to find a company's proposed capital structure unreasonable before it entertains an alternative capital structure would unnecessarily hamper the Commission's flexible approach to selection of the most reasonable capital structure.

The Commission agrees with the ALJ that NWB failed to demonstrate the reasonableness of its proposed capital structure for ratemaking purposes. NWB ultimately proposed a capital structure containing a 56.4% equity ratio. This equity ratio is considerably higher than the 50.1% equity ratio proposed by NWB witness Bauhard and authorized by the Commisison in *NWB,* P-421/GR-82-203, only five months prior to the filing of the instant case. In *South Central Bell v. Louisiana P.S.C.,* 373 So. 2d 48 (1979), the court concluded as follows:

> [It is not] imcumbent on the commission to find the company's actual capital structure unreasonable before it could set a rate of return on the basis of a hypothetical structure. Such a requirement would be anomalous, since South Central Bell is requesting the rate increase and, therefore, bears the burden of proving that the increase is due, in part, to its capital structure, **the company should also bear the burden of justifying the portion of the increase attributable to its management's choice of capital structure.** (Emphasis added)

NWB has failed to justify the reasonableness of the significant increase in its proposed equity ratio for ratemaking purposes since its last rate case.

NWB argues that, as a result of divestiture, the prior capital structure is no longer appropriate. However, NWB has introduced no evidence to demonstrate a shift in total risk or to quantify that total risk. Its main assertion is that an authorized equity ratio containing only 50.1% equity would cause a reduction in its bond rating. The Commissin finds this argument unconvincing. No reduction in the Company's bond rating was experienced when, as a consequence of the Company's last general rate proceeding, it was authorized a common equity component of 50.1% for regulatory purposes.

There is no evidence in the record, either, that maintenance of the highest possible bond rating alone is a legitimate regulatory goal. The Commission finds that the potentially lower cost of issuing debt afforded by a AAA bond rating will not automatically result in a lower overall cost of capital to a company and its ratepayers.

The Commission notes that NWB's actual capital structure at the time of *NWB*, P-421/GR-82-203 contained 61.1% common equity; use of this actual capital structure was not proposed by the Company or any other party in that proceeding. It is, therefore, illogical for NWB to now argue that failure to use NWB's actual capital structure in this proceeding would be inconsistent with the Commission's findings in *NWB*, P-421/GR-82-203.

The Company also suggests that, somehow, to allow less than a 55% equity ratio would either violate or materially interfere with the decision of the Federal Divestiture Court and the MFJ. Again, the Company attempts to use an Order of the Federal Court which was not entered for regulatory ratemaking purposes to, largely, avoid the issue. In the Company's last general rate proceeding, which concluded after the issuance of the MFJ, the Company supported a 50.1% common equity ratio. The Commission finds this argument by NWB to be without merit.

Based on the above findings and discussion, the Commission concludes that NWB has presented no convincing evidence as to the reasonableness of its capital structure for ratemaking purposes and has thus failed to sustain its burden of proof under Minn. Stat.

§ 237.075, subd. 4 (1983 Supp.). The Commission must now determine an appropriate and reasonable capital structure based upon competent evidence in the record.

The Commission agrees with the ALJ that the capital structure recommended by the RUD-AG, containing 44.6% debt and 55.94% equity, does not differ markedly from that proposed by NWB. The Commission does not find justification in the record for allowing such a significant increase in the equity ratio since *NWB*, P-421/GR-82-203.

The Commission finds, as did the ALJ, that the analysis and recommendation of DPS witness Thompson provides the basis for determining a fair and reasonable capital structure for NWB in this proceeding. Dr. Thompson's analysis provides the Commission with an objective benchmark for judging a reasonable capital structure for regulatory purposes, through his use of proxy companies with similar overall risk to NWB. The Commission used a similar analysis in evaluating the reasonableness of proposed capital structures in *Central Telephone Company*, P-405/GR-83-300 (March 30, 1984).

Dr. Thompson reviewed the five comparable company groups used by the rate of return witnesses in their initial testimonies: Mr. Morris' five telephone companies, Mr. Bauhard's 25 electric companies, Dr. Litzenberger's four electric companies and four telephone companies, and Dr. Amit's four telephone companies. The average common equity raio for these groups was 45.64%. None of these groups had equity ratios as high as the 56.4% proposed by NWB. The Commission finds that Dr. Thompson's analysis indicates that the five groups of companies are reasonably risk comparable to NWB as measured by beta and bond ratings. Therefore, based upon Dr. Thompson's analysis, the Commission concludes that no basis exists for increasing the equity ratio for NWB above the 50.1% level allowed in *NWB*, P-421/GR-82-203. The Commission adopts the ALJ's recommendation to use a 50.1% equity ratio in computing the overall rate of return to be allowed NWB in this proceeding.

The Commission finds it appropriate, as did the ALJ, to consider the 6.3% disallowed portion of equity as imputed debt, at a cost rate of 12.83%. Dr. Thompson derived the 12.83% cost rate based on the average yield of AA-rated utility bonds over the

preceding twelve month period. Using a relatively current cost of debt, rather than the embedded cost of existing NWB debt, is reasonable in this instance and consistent with the Commission's actions in *Northern States Power Company,* Docket No. G-002/GR-78-1052 (September 21, 1979).

Cost of Debt

The Commission observes that a cost of debt range exists on the record beginning with the estimate of 7.80% as of 1/1/84, prior to NWB's transfer of yellow pages and directory advertising services to US West, and ending with 8.5%, the final updated cost of debt which NWB claimed reflects a debt issuance of $150 million in March, 1984. The last cost of debt figure agreed to by all parties was 7.93% as of 1/3/84. The Commission finds it reasonable to reflect the $150 million debt issue since it was known before the close of the record in this proceeding. However, there was dispute over how that issuance affected NWB's embedded cost of debt. The Company did not provide actual numbers to substantiate its claim that the debt issue increased the Company's embedded cost of debt to 8.5%.

Due to the lack of actual Company figures on the embedded cost of debt and the lack of evidence on the record demonstrating the effects of the several transfers of equity and infusions of debt capital made by the Company in the course of this proceeding, the Commission finds that it has no alternative but to estimate NWB's embedded cost of debt. Since no actual numbers were provided by the Company to verify its constantly changing embedded cost of debt, the Commission cannot back-track to accurately relect the effect of the $150 million in new debt.

The Commission will adopt 8.22%, the average of the 7.93% and 8.5% as an appropriate cost of debt for regulatory purposes in this proceeding. The Commission finds the 8.22% to be a reasonable estimate of the embedded cost of debt, which gives weight to the March debt issue while recognizing the uncertainty in the record as to the effect of the debt issue. The Commission also serves notice to the Company that it must provide, in future general rate proceedings before this Commission, the actual data used to calculate its embedded cost of debt. If during the course of such future proceedings, changes occur in the Company's amount of debt, the

effect of such changes on the cost of debt shall also be accurately reflected with actual data.

As discussed more fully in the capital structure section, the Commission will use a 12.83% cost rate for the imputed debt in the capital structure.

Overall Rate of Return

Based on the findings and conclusions above, the Commission authorizes an overall rate of return of 11.63% for NWB, calculated as follows:

Source of Capital	% of Total Capital	Cost	Weighted Cost
Debt	43.60%	8.22%	3.58%
Imputed Debt	6.30%	12.83%	.81%
Common Equity	50.10%	14.46%	7.24%
	100.00%		11.63%

***

ORDER

1. Northwestern Bell Telephone Company is entitled to increased gross annual revenues of $45,603,000 so as to produce total annual revenues of $640,073,000 from Minnesota intrastate operations to eliminate both the gross revenue deficiency determined in this case and in *NWB*, P-421/CI-83-203 et al.

2. Within 20 days of the service date of this Order, the Company shall file with the Commission for its review and approval, and serve upon all parties in this proceeding, revised schedules of rates and charges determined in accordance with the total gross annual revenue requirement authorized in paragraph 1 above and the rate design decisions contained herein including the following:

   a. The Company shall make no adjustment in its rate calculations for estimated curtailment or shift (repression) of its test year customer base.

b. For each local exchange service provided to both business and residential customers, the Company shall calculate the rates to establish a ratio of 3.0 to 1.0 between the rates for business and residential customers in each tier of the metropolitan exchange, and a ratio of 2.5 to 1.0 between the rates for business and residential customers in the outstate exchanges.

c. The Company shall calculate revised metropolitan residential local exchange service rates to maintain the existing dollar amount differences between metropolitan residential tier rates and to set the metropolitan business tier rate differentials at 3 times the corresponding metropolitan residential tier rate differentials.

d. The Company shall increase rates for local measured services by the same percentage that rates for single-party flat-rate business and residential local exchange services are increased.

e. The Company shall retain all metered local exchange services and increase rates for these services by the same percentage that rates for single-party flat-rate business and residential local exchange services are increased.

f. The Company shall retain all multi-party local exchange services and shall increase rates for these services by the same percentage that rates for single-party flat rate business and residential local exchange services are increased.

g. The Company shall set the rates for semi-public coin telephone service at the same level calculated for single-party flat-rate business local exchange service.

h. The Company shall retain the PBX trunk rate designation and shall set the rates for this service at levels equal to 115% of the rates for single-party flat-rate business local exchange service.

i. The Company shall retain the multi-line (key) rate designation for business and residential customers, and shall set rates for these services at levels equal to 105% of the corresponding rates for single-party flat-rate business and residential local exchange services.

j. The Company shall set the revised rates for centrex and group use exchange access lines at the same levels calculated for PBX trunks.

k. The Company shall increase rates for extended area service by the same percentage single-party flat rate business and residential local exchange services are increased.

l. The Company shall increase the surcharges for operator assisted long distance calls by the same percentage that rates for single-party flat-rate residential local exchange services are increased. The Company shall round the revised rates to the nearest 5 cents.

m. The Company shall revise rates for touch-tone service provided in association with each category of local exchange service to reflect the rate changes authorized for those services. The Company shall eliminate the touch-tone charge applied to centrex extenson stations and apply the same touch-tone rate to business 1-party flat rate local service and semi-public coin telephone service. The Company shall provide touch tone service to qualified physically or mentally impaired persons without charge.

n. The Company shall increase rates for custom calling features to the levels it proposed in its initial filing except that the Company shall provide the speed-calling 8 feature to physically or mentally impaired persons without charge.

o. The Company shall eliminate the 53e directory assistance credit and increase rates for calls to directory service from 20 to 25 cents as it proposed in its initial filing. The proposal to increase the rates for directory assistance calls placed through the "0" operator is rejected.

p. The Company shall increase rates for private line services not involved in the Revised Private Line Case as it proposed in its initial filing.

q. The Company shall implement any other uncontested proposals as it proposed in its initial filing.

3. The Company shall provide, with the schedule of rate and charges referred to in paragraph 2 above, supporting documentation which demonstrates that the proposed schedule of rates will generate the level of revenues authorized in paragraph 1 above.

4. Within 20 days of the service date of this Order, the Company shall file with the Commission for its review and approval, and serve upon all parties in this proceeding, a proposed customer notice explaining the final prospective rates.

5. Any party wishing to submit comments regarding the filings from paragraphs 2, 3, and 4 above shall submit such comments to the Commission and all parties in this proceeding, in writing, within 10 days of service by the Company.

6. The Company shall, in all future rate case filings, identify the present and proposed test year revenues, and the present and proposed test year number of customers or revenue producing units, for all major categories of service provided to customers or exchange access provided to other carriers.

7. The Company shall make an annual report regarding the revenues, expenses, and prepaid directory expenses associated with the provision of directory operations as specified in Section VI, subpart X, of the Operating Income Statement portion of this Order. The annual report for each calendar year shall be due by March 31 of the subsequent year. The Company shall provide any missing information for past calendar years within 60 days of the service date of this Order.

8. Pending the Commission's decision in *NWB*, P-421/M-85-816, the Company shall apply rates determined under prior contractual agreements for service provided all conventional radio common carriers as permanent rates, shall apply proposed Feature Group A & E access rates for services provided to NewVector as permanent rates, and shall apply the rates originally proposed in *NWB*, P-421/M-84-189 for services provided to MCI/Cellcom Cellular as interim rates.

9. The Motions for Dismissal filed by the Recipient Families United for Justice, the St. Cloud Area Ratepayers, Even J. Henry, the Minnesota Public Interest Research Group and the Minnesota Senior Federation are hereby denied.

10. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Mary Ellen Hennen
Executive Secretary

(SEAL)
0574F

APPENDIX 10

BEFORE THE
MINNESOTA PUBLIC UTILITIES COMMISSION

Barbara Beerhalter	Chair
Harry Seymour Crump	Commissioner
Cynthia A. Kitlinski	Commissioner
Roger J. O'Keefe	Commissioner
Darrel L. Peterson	Commissioner

Docket No. U-999/CI-86-177
Issue Date: June 4, 1987

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners

ORDER DENYING RECONSIDERATION

Procedural History

On April 9, 1986, the Minnesota Public Utilities Commission (the Commission) issued its Order Initiating Investigation in this docket. In that Order, the Commission directed the Minnesota Department of Public Service (DPS) to conduct an independent investigation to asses whether any improper communications occurred during Commission proceedings addressing issues of significant financial impact to regulated companies or addressing significant policy issues likely to lead to a significant financial impact on regulated companies. The Commission directed that the investigation cover at least the last several months of the Commission terms of former Commissioners Juanita R. Satterlee, Roger L. Hanson, and Leo G. Adams. The Commission could then use this investigation to remedy any improper influence caused by these contacts.

On July 8, 1986, the DPS submitted its "Report of the Depart-

ment of Public Service to the Minnesota Public Utilities Commission" (the DPS Report). The DPS also submitted the depositions and documents that it obtained in the course of its investigation as supporting exhibits to the DPS Report. On August 13, 1986, Northwestern Bell Telephone Company (NWB) filed a response to the DPS Report.

On July 9, 1986, the Residential Utilities Division of the Office of the Attorney General (RUD-AG) filed a petition requesting the Commission to reopen and reconsider its July 27, 1984, Findings of Fact, Conclusions of Law, and Order in *Northwestern Bell Telephone Company*, Docket No. P-421/GR-83-600 (*NWB 83-600*). On July 18, 1986, NWB filed its reponse to the RUD-AG petition. On August 1, 1986, the RUD-AG filed a reply brief to NWB's response. On September 15, 1986, NWB responded to the RUD-AG reply brief.

On August 14, 1986, the Minnesota Public Interest Research Group (MPIRG) filed a petition requesting that the Commission vacate and dismiss its July 27, 1984 and November 13, 1984 Orders in *NWB 83-600*. On September 15, 1986, NWB responded to MPIRG's petition.

On October 3, 1986, the Commission issued its Order Establishing Procedures and Soliciting Briefs in this matter. On October 23, 1986, United Telephone Company (United), the Suburban Rate Authority (SRA), MPIRG, RUD-AG, NWB and the DPS filed comments or briefs. On October 24, 1986, the Minnesota Business Utility Users Council (MBUUC) filed a letter addressing this matter and U.S. Sprint filed a brief. On Novebmer 3, 1986, NWB filed its Reply to the submissions of the other parties.

Oral argument was held on November 6, 1986; representatives of the DPS, the RUD-AG, MPIRG, the SRA, the MBUUC, AT&T, and NWB participated.

On April 2, 1987, the Commission issued its Order After Investigation and Vacating July 27, 1984 Order in Docket No. P-421/GR-83-600 (April 2 Order) in this proceeding. In that Order the Commission voided its July 27, 1984 Order in *Northwestern Bell Telephone Company*, Docket No. P-421/GR-83-600 and reopened that case for further deliberation and the issuance of a new decision and order.

On April 16, 1987, NWB filed a Petition for Reconsideration and

Vacation in this matter. On April 27, 1987, the RUD-AG filed a Memorandum in Opposition to the NWB Petition and the DPS filed its Reply to the NWB Petition. MPIRG filed its Reply to the NWB Petition on May 4, 1987.

On May 27, 1987, the Commission met to consider NWB's petition and the responsive pleadings of the other parties.

FINDINGS AND CONCLUSIONS

The Commisison finds that in its Petition for Reconsideration and Vacation NWB relied on arguments it has previously made in this proceeding and which the Commission exhaustively addressed in its April 2 Order. The Commission reaffirms its earlier findings and conclusions on the seriousness of the abuse NWB inflicted on the regulatory process and also reaffirms the Commission's legal authority to reopen this matter. However, the Commission will clarify its findings in regard to two of NWB's positions on reconsideration.

First, NWB asserts that its due process rights were violated in this proceeding because the Commission did not refer this matter for a contested case hearing.

The Commission reminds NWB that its October 3, 1986 Order Establishing Procedures and Soliciting Briefs in this matter gave all parties an opportunity to comment on and make recommendations on the process the Commission would use. Specifically, that Order requested parties to address five questions in their briefs on whether *NWB 83-600* or any other Commission decisions in the relevant time period were improperly influenced due to a conflict of interest or ex parte communications between former Commissioners Adams, Hanson, or Satterlee and regulated companies. The fifth question to be addressed was: "Is the evidence contained in the DPS Report, depositions and exhibits sufficient for the Commission to resolve the questions posed above? If not, identify specific evidence challenged or to be introduced that a party believes is necessary for the commission to resolve the questions."

In its October 23, 1986 Comments in response to the Commission's October 3, 1986 Order, NWB simply stated that it would object to reopening any of the dockets in question based on the depositions and exhibits provided by the DPS. NWB further stated

that since no violation of statutes or rules occurred even under that evidence and since the Commission had no authority to reopen the dockets, "there is no need for additional proceedings to resolve these evidentiary problems." However, NWB did not in any of its comments or responsive pleadings following the October 3, 1986 Order offer additional evidence nor did it request a process to develop further evidence.

Furthermore, it is axiomatic that the purpose of a contested case hearing is to resolve disputed material facts. The Commission finds that there is no dispute regarding the material facts that led to the reopening of *NWB 83-600* and concludes that a contested case hearing was not necessary in this proceeding. Throughout this matter, the Commission has recognized, addressed, and protected NWB's due process rights.

Second, in an extension of its argument on the Commission's authority to reopen *NWB 83-600*, NWB asserted that the Commission is bound by the Minnesota Supreme Court decision in *Henry v. Public Utilities Commission*, 392 N.W.2d 209 (Minn. 1986). That decision held that the rates established in *NWB 83-600* are just and reasonable. NWB argued that the *Henry* decision requires the Commission to vacate its April 2 Order in this proceeding. The Commission disagrees. The issue of abuse of the Commission's process which is the legal basis for redeliberating *NWB 83-600* was not before the Court in *Henry*. That decision did not address the abuses of the regulatory process that the Commission has determined undermined the integrity of the decisionmaking process in *NWB 83-600*. Therefore, the Commission concludes that the *Henry* decision is no longer relevant and that the Commission has correctly reopened *NWB 83-600* for redeliberation.

The Commission finds NWB has not raised any issues or matters that the Commission has not previously considered. The Commission concludes that there is no basis to alter its April 2, 1987 Order After Investigation and Vacating July 27, 1984 Order in Docket No. P-421/GR-83-600 in this proceeding. Therefore, the Commission will deny NWB's Petition for Reconsideration and Vacation.

ORDER

1. Northwestern Bell Telephone Company's Petition for Reconsideration and Vacation is hereby denied.
2. This Order shall become effective immedicately.

BY ORDER OF THE COMMISSION

Mary Ellen Hennen
Executive Secretary

(SEAL)

MEH:sj
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APPENDIX 11

STATE OF MINNESOTA
IN COURT OF APPEALS
#C7-87-1296
#C9-87-1297

Minnesota Public Utilities Commission

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commissioners. (C7-87-1296)

In the Matter of the Petition of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota. (C9-87-1297)

OPINION

SEDGWICK, Judge.

In separate appeals to this court, relator Northwestern Bell has requested review of two orders by the Public Utilities Commission which vacated and modifed a prior 1984 rate order. We consolidated the two appeals. We affirm in part and reverse in part.

FACTS

This case has a complex and lengthy procedural history. On September 29, 1983, Northwestern Bell filed a petition with the Minnesota Public Utilities Commission ("Commission"), seeking a $109 million annual rate increase. Between January and April 1984, hearings on the petition were conducted by an administrative law judge ("ALJ"). The proceedings concerning this petition are referred to as "Docket 600."

On May 16, 1984, intervenors Minnesota Public Interest Research Group ("MPIRG"), Evan Henry, and the Department of Public Service ("DPS") petitioned the ALJ for dismissal of Northwestern Bell's pending rate case, because Northwestern Bell had filed a res-

tructuring plan with the Federal Communications Commission in January 1984 which was presented to the Minnesota Commission in April. The Commission ordered the DPS to investigate the fincnacial effect of Northwestern Bell's restructuring on the pending rate action. Northwestern Bell and the DPS subsequently stipulated that the effect of the reorganization should be considered within the context of the rate proceeding, and the DPS withdrew its motion to dismiss.

Before the DPS investigation was completed, however, the ALJ recommended to the Commission that the rate petition be dismissed, because it appeared tht the financial effect of Northwestern Bell's reorganization would be substantial. On June 8, 1984, the Commission voted 2 to 1 not to dismiss the rate petition, but to consider the effect of Northwestern Bell's corporate restructuring in the context of the rate proceeding. Commissioners Leo Adams and Roger Hanson voted not to dismiss. Prior to the Commission's vote, Commissioner Hanson wrote and distributed a memorandum recommending denial of the motion to dismiss.

Following the completion of the contested case proceeding, the ALJ recommended that the Commission award Northwestern Bell a $36.1 million rate increase. On July 27, 1984, the Commission granted Northwestern Bell a rate increase of $57,511,000.

In August and September 1984, the Commission heard petitions for rehearing and modification. The DPS recommended reduction of the rate increase by $363,000. The Commission, on its own motion, ordered a rehearing and reopening of the record, and on September 26, 1984, the Commission adopted the DPS recommendation, and modifed the rate increase from $57,511,000 to $57,148,000.

Intervenor Henry appealed the Commission's decision, claiming that the Commission's final decision was untimely, because it was not rendered within ten months from the date of Northwestern Bell's petition for a rate increase; that the Commission should have conducted a second contested case hearing before it modified the original order; and that Northwestern Bell had not met its burden of proving the new rates were just and reasonable.

The case was appealed to the Minnesota Supreme Court, which concluded that the Commission had acted within its statutory authority in ordering a rehearing; that the Commission was not required

to hold a contested case hearing before it modified its decision; that the summary procedure adopted by the Commission for rehearing did not deprive Henry of due process; and that the decision of the Commission regarding Northwestern Bell's rates was supported by the record and was not arbitrary and capricious. *Henry v. Minnesota Public Utilities Commission,* 392 N.W.2d 209 (Minn. 1986).

On April 9, 1986, prior to the supreme court's decision in *Henry*, the Commission ordered an investiagtion of the proceedings which led to its decision in Docket 600. This investigation, referred to as Docket 177, concerned reports alleging that numerous ex parte contacts had occurred between former Commissioners Adams and Hanson, and a representative of Northwestern Bell, Roy Weir, during the pendency of Docket 600 and other cases. On July 8, 1986, the DPS issued a report which concluded, in part, that during the months Docket 600 was pending before the Commission, Weir had met on numerous occasions with Commissioners Adams and Hanson in restaurants; that Northwestern Bell had paid for those meals; that Weir and the two Commissioners all testified in depositions that those meetings had not involved discussions of Docket 600 issues; that during the time Docket 600 was pending before the Commission there was no statute or rule in Minnesota which prohibited ex parte contacts between Northwestern Bell and the Commission or which prohibited Northwestern Bell from paying for meals consumed by Commissioners; and that it was unlikely that Commissioners could be bribed with free meals. The DPS report did not recommend reopening or reconsidering Docket 600.

On July 9, the Attonery General petitioned to reopen and consider Docket 600, and on August 14, 1986, MPIRG petitioned to vacate and dismiss Docket 600, based upon the ex parte communications between Weir and the two Commissioners. Subsequently, on October 3, 1986, the Commission issued an order inviting briefs and comment from all of the parties involved. On October 22, 1986, the DPS issued a second report, recommending that the Commission redeliberate its decision in the 1984 rate order.

On November 7, 1986, the Commission began deliberating whether it should take any new action regarding the 1984 rate order. The Commission thereafter voted to approve the Attorney General's petition to reconsider the 1984 rate order.

Between February 12 and 19, 1987, the Commission reconsidered

the issues involved in Docket 600, and on April 2, 1987, the Commission issued a final order vacating the 1984 rate order and reopening that order for further deliberation and issuance of a new decision and order. Two days later the Commission issued its new decision, modifying certain terms and reducing Northwestern Bell's rates from $57,148,000 to $45,603,000. This final decision was rendered without conducting a new contested case hearing.

The Commission made the following changes to the 1984 order:

(1) The Commission used a hypothetical capital structure to set Northwestern Bell's rates;

(2) The Commission imputed hypothetical directory revenues to Northwestern Bell as the result of a transfer of Northwestern Bell's directory publication to an independent company;

(3) The Commission continued the requirement that Northwestern Bell reduce its rates due to a tax surplus; and

(4) The Commission required that Northwestern Bell provide Touch-Tone and Speed Call 8 services free to eligible handicapped customers.

In two separate appeals to this court, Northwestern Bell has challenged the Commission's actions. In appeal No. C7-87-1296, Northwestern Bell challenged the commission's determination that Weir engaged in improper contacts with Commissioners Adams and Hanson, which affected the Commission's original 1984 rate order. Northwestern Bell also claims that the Commission had no authority to reopen the 1984 order; that the supreme court decision in *Henry* bars this action under the doctrine of res judicata; that the Commission's order to reopen violates the 10-month rule of Minn. Stat. § 237.05; and that the Commission's prodedures violated Northwestern Bell's constitutional and statutory rights.

In appeal No. C9-87-1297, Northwestern Bell has challenged the changes which the Commission actually made to the 1984 rate order.

ISSUES

1. Did the Commission have the authority in 1987 to conduct an investigation of its 1984 rate order?
2. Did the Commission's actions violate the 10-month rule of Minn. Stat. § 237.075 (1986)?
3. Did the Commission have the authority to vacate its 1984 rate order based upon "fraud on the tribunal"?
4. Did the Commission deny Northwestern Bell certain procedural rights?
5. Did the Commission err by failing to consider issues raised in Northwestern Bell's motion for reconsideration?
6. Did the Commission err by establishing prospective rated based upon 1983 test year financial data?
7. Did the Commission err by employing a hypothetical capital structure when modifying Northwestern Bell's rate?
8. Did the Commission improperly impute hypothetical directory revenues to Northwestern Bell?
9. Did the Commission erroneously require Northwestern Bell to reduce its customers' rates due to a tax surplus which had already been depleted?
10. Did the Commission err by requiring Northwestern Bell to provide certain services to handicapped customers free of charge?

ANALYSIS

1. Investigation and Hearing.

Northwestern Bell objects to the summary investigation by the DPS and the evidence obtained therefrom, complaining that it was required to respond to discovery requests even though the DPS refused itself to respond to any requests for information. Northwestern Bell also claims that the Commission should have ordered a contested case hearing, since the reasonableness of its rates was at issue.

We find Northwestern Bell's complaints to be without merit. In so doing, we rely upon the following language in *Henry*:

> Minn. Stat. § 237.081, subd. 1 (1984) provides the MPUC may, on its own motion, summarily investigate any matter relating to any service it believes "for any reason" should be examined. If, after making such

> summary investigation, the MPUC is satisfied there are sufficient grounds to warrant a formal hearing on the matters investigated, it may initiate such a hearing. Minn. Stat. § 237.081, subd. 2 (1984).

Henry, 392 N.W.2d at 212 n.1.

Henry also explained that a contested case hearing is required only if the Commission has determined that "significant issues" cannot be resolved to the satisfaction of the Commission. *Id.* at 214. Since the Commission did not order a contested case hearing, it must have concluded that the reasonableness of the rates was not a significant issue which could not be resolved to the satisfaction of the Commission.

We also note that although Northwestern Bell objected to the summary investigation, at the time it did not specifically request a contested case hearing, but instead argued that there was no need for the Commission to take any action whatsoever regarding the 1984 order.

2. Ten-Month Rule.

Northwestern Bell claims the Commission's order reopening the 1984 rate order violated the 10-month rule of Minn. Stat. § 237.075, subd. 2 (1986), which provides in part:

> If the commission does not make a final determintaion concerning a schedule of rates within ten months after the initial filing date [of the original petiton for an increase in rates], the schedule shall be deemed to have been approved by the commission ***. For the purpose of this section, "final determination" means the initial decision of the commission and not any order which may be entered by the commission in response to a petition for rehearing or other relief.

Under similar circumstances, the supreme court in *Henry* rejected Northwestern Bell's claim that the Commission's reopening of a portion of its 1984 order constituted an improper effort to circumvent the 10-month statutory limitation. The *Henry* court explained:

> The statutory time limit refers only to the period during

> which rates may be suspended and is not a temporal limit on the MPUC's jurisdiction ***. The clear purpose of the provision is to protect utilities from the potentially confiscatory effect of regulatory delay. In other cases where we have interpreted similar statutory time limits, we have construed these provisions as directory and not mandatory, stating the time limit *** '[is] obviously designed merely to secure order, uniformity, system, and dispatch in the public business." *** Consistent with these cases, we conclude subdivision 2 does not deprive the MPUC of jurisdiction to issue a decision in a rate proceeding if it fails to reach a decision within the 10-month suspension period.

392 N.W.2d at 213-14 (citation omitted). In view of the above language, we reject Northwestern Bell's argument that the 10-month rule barred the Commission's reopening and modification of the 1984 order.

3. Fraud on the Commission.

Northwestern Bell points out that the ex parte contacts between Weir and Commissioners Hanson and Adams were not actually prohibited by statute in 1984. In fact, Northwestern Bell argues that certain rules and statutes in existence at the time suggested that such lobbying of the commission was to be expected.

Minn Stat. § 216A.02 (1984) defines the Commission's three functions: legislative, administrative and quasi-judicial. Certainly, in matters of the Commission's legislative and administrative functions, some discussion with representatives of the utilities which it regulates is to be expected. However, in matters concerning the Commission's quasi-judicial function, such contacts cannot be condoned.

The Commission did not address the question whether Northwestern Bell's ex parte contacts with the Commission members were illegal; rather, the Commission looked at whether those ex parte contacts constituted an abuse of process, or a type of fraud upon the Commission.

In Minnesota, a court may vacate a judgment within a specific period of time due to extrinsic or intrinsic fraud. Minn. R. Civ. P. 60.02. Rule 60 also recognizes and distingushes the type of case where "fraud upon the court" is alleged. In discussing this doctrine,

one commentator has stated:

> Fraud upon the court differs from extrinsic or intrinsic fraud. *** Some federal courts have attempted to define fraud upon the court as conduct which defiles the court itself or in which court officers conduct themselves in a way as to impair judicial machinery and prevent an impartial adjudication. *** Other courts have defined this type of fraud as an unconscionable plan or scheme to improperly influence the court in its decision. ***
>
> *** The concept clearly includes bribery of a judge or the employment of counsel in order to bring an improper influence on the court.

2A D. Herr & R. Haydock, *Minnesota Practice* § 6024 (1985) (citations omitted).

In *Halloran v. Blue and White Liberty Cab Co.*, 253 Minn. 436, 92 N.W.2d 794 (1958), the Minnesota Supreme Court stated:

> A judgment may be set aside at any time for after discovered fraud upon the court. Where a court is misled as to material circumstances, or its process is abused, resulting in the rendition of a judgment which would not have been given if the whole conduct of the case had been fair, the court has inherent power to vacate for fraud and that power includes as well the power to modify.

Id. at 442, 92 N.W.2d at 798.

In *Hazel-Atlas Glass Co. v. Hartford-Empire Co.*, 322 U.S. 238 (1944), the Supreme Court recognized the abhorrence with which "fraud upon the court" is viewed. the *Hazel-Atlas* court stated:

> [T]ampering with the administration of justice in the manner indisputably shown here involves far more than an injury to a single litigant. It is a wrong against the institutions set up to protect and safeguard the public,

> institutions in which fraud cannot complacently be tolerated consistently with the good order of society.

Id. at 246.[1]

We recognize that Rule 60.02 and the *Halloran* decision govern fraud on the "court," and do not address the question whether a similar doctrine should be held to exist within the administrative process. Northwestern Bell argues that the Commission has no similar authority to reopen orders based on "fraud on the Commission," since the legislature has not expressly given the Commission such authority.

In *WKAT, Inc. v. Federal Communications Commission*, 296 F.2d 375 (D.C. Cir. 1961), the Federal Communications Commission had awarded an application for a permit to construct a television station. While an appeal to the court was pending, information came to light which indicated that WKAT had improperly sought to influence the results of the application. The court remanded the case for an evidentiary hearing on the misconduct, and the Commission appointed a master, conducted hearings, and issued an order disqualifying the applicants. The court subsequently held the order proposed by the Commission to be within its authority.

While the Commission in *WKAT* was proceeding according to the directives of the court, the *WKAT* opinion suggests that administrative agencies should have the same inherent power to reopen their judgments that is accorded the courts under the doctrine of fraud upon the court:

> This doctrine applies to the adjudicatory functions of an administrative agency. This is not a mere techicality. Surreptitious efforts to influence an official charged with the duty of deciding contested issues upon an open record in a court with basic principles of our jurisprudence, eat the very heart of our system of government—

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[1]Northwestern Bell takes the position that the Commission erroneously based its decision to reopen the 1984 rate order on its unsupported belief that the public distrusted the process. Whether or not the public actually distrusted the process, the *Hazel-Atlas* decision recognizes that the process is designed for the benefit of the public, and should not be abused.

> due process, fair play, open proceedings, unbiased, uninfluenced decision. He who engages in such efforts in a contest before an administrative agency is fortunate if he loses no more than the matter involved in that proceeding.

Id. at 383.

In Minnesota, two recent appellate decisions have discussed the question whether an agency has powers which have not been specifically delegated by statute. In *Senior Citizens Coalition v. Minnesota Public Utilities Commission*, 355 N.W.2d 295 (Minn. 1984), the supreme court stated:

> The PUB is a state agency of statutory origin. *** As such, it has only that jurisdiction conferred to it by the legislature. *** "A lack of statutory authority betokens a lack of jurisdiction."

Id. at 302 (quoting *State ex rel. Spurck v. Civil Service Board*, 226 Minn. 253, 259, 32 N.W.2d 583, 586 (1948)).

In *Peoples Natural Gas Co. v. Minnesota Public Utilities Commission*, 369 N.W.2d 530 (Minn. 1985), the court again indicated that a lack of express statutory authority required reversal of a Commission decision. There, again, the court hled that the Commission does not have implied authority:

> Neither agencies nor courts may under the guise of statutory interpretation enlarge the agency's powers beyond that which was contemplted by the legislative body.

Id. at 534 (quoting *Waller v. Powers Department Store*, 343 N.W.2d 655, 657 (Minn. 1984)).

We find the *Senior Citizens* and *Peoples* cases distinguishable, since in those cases the Commission had attempted to exercise an implied authority to award costs or refund revenues, whereas here, the Commission was simply attempting to correct a previous order. We also rely upon a line of Minnesota cases which suggests that the Commission had the implied authority to reopen its 1984 decision.

In 1958, the Minnesota Supreme Court recognized that administrative agencies have powers similar to those exercised by the courts under Rule 60. In *Anchor Casualty Co. v. Bongard Co-operative Creamery Association*, 253 Minn. 101, 91 N.W.2d 122 (1958), the court stated:

> While it is true that the statute in question, § 27.06, does not specifically grant to the commissioner the power to open and rehear matters, neither does it deny that power to him. ***
> *** It is generally recognized that one of the powers proper to an efficient and just administration of the right to adjudicate is the power to reverse and adjudication which appears to be erroneous. (Federal Rules of Civil Procedure, Rule 60[b].) This power lasts until jurisdiction is lost by appeal or certiorari or until a reasonable time has run ***.

Id. at 105-06, 91 N.W.2d at 125-26. Citing *Handlon v. Town of Belleville*, 4 N.J. 99, 106, 71 A.2d 624, 627 (1950), the court stated:

> Barring statutory regulation, the power may be invoked by administrative agencies to serve the ends of essential justice and the policy of law. But there must be reasonable diligence. The denial to such tribunals of the authority to correct error and injustice and to revise its judgments for good and sufficient cause would run counter to the public interest. The function cannot be denied except by legislative fiat; and there is none such here. The power of correction and revision, the better to serve the statutory policy, is of the very nature of such governmental agencies.

Id. at 106, 91 N.W.2d at 126. In *State ex rel Turnbladh v. District Court*, 259 Minn. 228, 107 N.W.2d 307 (1960), also, the court stated:

> [A]n administrative agency has a well-established right to reopen, rehear, and redetermine the matter even after a

determination has been made. This is a rule of general application.

Id. at 236, 107 N.W.2d at 312. The *Turnbladh* and *Anchor Casualty* cases have been recently cited with approval. *See, e.g., Stearns-Hotzfield v. Farmes Insurance Exchange*, 360 N.W.2d 384, 389 (Minn. Ct. App. 1985).

This line of cases recognizes that an administrative agency has the inherent power to correct its prior decisions. In the past, these decisions have been limited to the "normal" Rule 60 situation, where the power of the tribunal is limited by time constraints. However, since administrative agencies hve been accorded a Rule 60 type of authority to reopen and consider decisions based upon allegations of extrinsic or intrinsic fraud, we the Commission must also possess the implied authority to reopen judgments at anytime based on the "fraud on the court" doctrine recognized by Rule 60.02.

The Commission determined that the number and timing of the ex parte contacts between Northwestern Bell and Commissioners Hanson and Adams sustained the inference that Northwestern Bell's actions were intended to influence tht Commission's decision in Docket 600. The record supports the Commission's determination. During the time the Commission was deliberating on Northwestern Bell's petition for a rate increase, numerous meetings were held between Weir and Commissioner Adams and Hanson. Those meetings were all paid for by Northwestern Bell. The dates upon which Weir paid for meals for Commissioners Hanson and Adams occurred during the time Docket 600 was pending before the Commission. The evidence is more than sufficient to sustain the Commission's inference that Northwestern Bell's actions were intended to influence the commission, and therefore constituted a fraud on the commission. *See Gibson v. Civil Service Board*, 285 Minn. 123, 171 § 712 (1969) (an agency's reasonable inferences from the facts should be sustained if there is substantial evidence in the record tending to support those inferences).

Nevertheless, Northwestern Bell argues that there has been no proof that the improper ex parte contacts actually affected the

Commission's final rate decision.[2] We disagree.

As the supreme court recently stated in a similar situation:

> While the record contains no direct evidence that Adams unduly influenced the decision, his mere presence creates the obvious appearance of impropriety and undermines the public confidence in the system. We are incredulous that these sophisticated governmental and utility officials could have assumed otherwise. We therefore hold that there is substantial evidentiary support for the findings of the Commission that the individuals had a duty to disclose their association, that Adams has a substantial conflict of interest and that the proceedings were tainted as a result.

In re Northern States Power Co., ___ N.W.2d ___, slip op. at 7 (Minn. Oct. 23, 1987).

Here, after hearing the testimony of the parties, the ALJ, who was uninfluenced by the ex parte communications, recommended the adoption of a $36.1 million rate increase. The Commission, however, voted to grant Northwestern Bell a rate increase in the

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[2]In *PATCO v. Federal Labor Relations Authority*, 685 F.2d 547, 564 (D.C. Cir. 1982), the court noted that improper ex parte communications do not render agency proceedings automatically void, but voidable. The *PATCO* court set forth the following standards for determining whether an agency's decision should be vacated:

> [A] court must consider whether, as a result of improper ex parte communications, the agency's decision making process was irrevocably tainted so as to make the ultimate judgment of the agency unfair, either to an innocent party or to the public interest that the agency was obliged to protect. In making this determination, a number of considerations may be relevant: the gravity of the ex parte communications; **whether the contacts may have influenced the agency's ultimate decision; whether the party making the improper contact benefited from the agency's ultimate decision;** whether the contents of the communications were unknown to opposing parties, who therefore had no opportunity to respond; and whether vacation of the agency's decision and remand for new proceedings would serve a useful purpose.

Id. at 564-65 (footnotes omitted (emphasis added).

amount of $57,511,000. This discrepancy provides further support for the Commission's subsequent determination that the proceedings in Docket 600 were tainted by the ex parte contacts.

4. Denial of Oral Argument.

The Commission based its 1987 order upon the record compiled during the 1984 contested case proceedings. In modifying the 1984 decision in April 1987, the Commission did not afford Northwestern Bell an opportunity to present oral argument on the merits. The Commission also issued its order denying reconsideration of the April 1987 decision without allowing Northwestern Bell an opportunity to present oral argument. Northwestern Bell claims the denial of oral argument before the new Commissioners in 1987 constituted a deprivation of its constitutional and statutory rights.

Minn. Stat. § 14.61 (1986), cited by Northwestern Bell, is entitled "Agency Decision in Contested Case," and provides:

> In all contested cases the decision of the officials fo the agency who are to render the final decision shall not be made until *** an opportunity has been afforded to each party adversely affected to file exeptions and present argument to a majority of the officials who are to render the decision.

This statute clearly refers to a final decision after a contested case hearing, and therefore would have required oral argument in 1984. Northwestern Bell does not claim it was denied oral argument in 1984.

In 1987, when the Commission reopened the 1984 order and issued a new decision on the merits, there was no statute requiring that the parties be allowed to present a second oral argument. Indeed, there was no statute which provided for the procedures used by the Commission in reopening and reconsidering the 1984 order; thus, we believe basic notions of fairness in the decison-making process should control.

The equities weigh against oral argument in the present situation. Northwestern Bell argues that basic concepts of fair play require the allowance of a new opportunity to present oral argument; however, because the ex parte contacts between Northwestern Bell and the Commission in fact constituted fraud on the Commission,

Northwestern Bell, itself, cannot be deemed to have engaged in fair play from the beginning. The maxim "He who seeks equity must do equity" is applicable here.

5. Order on Reconsideration.

Northwestern Bell claims that, upon reconsideration of its April 1987 order, the Commission failed to address several issues. In its order denying reconsideration, the Commission stated:

> The Commission finds that the parties have raised no new arguments or evidence in Petitions for Reconsideration that have not already been thoroughly considered by the Commission.

Northwestern Bell claims that several new arguments were raised in its petition for reconsideration, and the Commission therefore erred by determining that these new arguments had been previously considered. We find this claim to be without merit.

6. Financial Data.

Northwestern Bell also argues that the Commission improperly used 1983 test year data in making its 1987 modifications to the 1984 rate order. This argument fails to take into consideration the fact that the 1987 order was simply a modification of the prior 1984 order, and not a consideration of a new request by Northwestern Bell for prospective rate increases. The Commission clearly had no authority to use 1987 data, since a new contested proceeding had not been conducted. Use of the 1983 test year data was therefore proper.

7. Hypothetical Capital Structure.

Northwestern Bell argues that the Commission had no authority to reevaluate its capital structure, since in *Henry*, the Minnesota Supreme Court had already affirmed the reasonableness of the capital structure established in the 1984 rate order.

While *Henry* determined that the rates set by the Commission in its 1984 order were reasonable, where fraud upon the court is alleged, the principal of res judicata may not be invoked. *See Halloran*, 253 Minn. at 442, 92 N.W.2d at 798.

Northwestern Bell also argues that the Commission erroneously imposed upon it the burden of proving its capital structure reasonable. Our supreme court recently rejected this argument in *In re*

Northern States Power Co., ___ N.W.2d ___ (Minn. Dec. 11, 1987):

> [E]nactment of Minn. Stat. § 216B.16, subd. 4 (1986) *** placed on the petitioning utility the burden of proving the proposed rate is fair and reasonable, and, as a component of the rate base, that the capital structure debt-equity allocation is fair and just. When, in the Commission's judgment, a petitioning utility has failed to establish the reasonableness of costs which it claims justifies a proposed rate increase, the Commission itself may compute a hypothetical capital structure that will afford an ultimate determination of a reasoanble and just rate.

Id., slip op. at 11 (citation omitted). The Commission therefore correctly assigned to Northwestern Bell the burden of proving its capital structure reasonable.

The *Northern States Power* court also explained the scope of this court's review when the Commission has adopted a hypothetical capital structure:

> [Whether] the Commissioner has adequately articulated its reasoning employed to reach its conclusion that [a utility] had failed to estalish the proposed rate as being "just and reasonable", and [whether] the Commission's conclusion itself was reasonable.

Id., slip op. at 12-13.

Here, the commission articulated the following reason for its determination in 1987 that Northwestern Bell's proposed equity ratio was not just and reasonable:

> NWB ultimately proposed a capital structure containing a 56.4% equity ratio. This equity ratio is considerably higher than the 50.1% equity ratio proposed by NWB witness Bauhard and authorized by the Commission in [another rate case], only five months prior to the filing of the instant case.
>
> ***
>
> NWB argues, that, as a result of divestiture, the prior

> capital structure is no longer appropriate. However, NWB has introduced no evidence to demonstrate a shift in total risk or to quantify that total risk. Its main assertion is that an authorized equity ratio containing only 50.1% equity would cause a reduction in its bond rating. The Commission finds this argument unconvincing. No reduction in the Company's bond rating was experienced when, as a consequence of the Company's last general rate proceeding, it was authorized a common equity component of 50.1% for regulatory purposes.

The record supports the Commission's rejection of Northwestern Bell's proposed equity ratio.

There is substantial evidence in the record supporting the Commission's adoption of a 50.1 percent hypothetical equity ratio. First, the capital structure used by the Commission in Northwestern Bell's prior 1982 rate case included a 50.1% equity ratio. Further, DPS witness Dr. Luther Thompson recommended a capital structure of 50% equity, 43.6% debt and 6.4% imputed debt. This recommendation was based on the average equity ratios of four telephone companies analyzed by one witness, five telephone compaines analyzed by a witness for the Attorney General, 25 electric companies analyzed by a witness for Northwestern Bell, and four telephone companies and four electric companies analyzed by another witness. Dr. Thompson had selected these groups because their average bond ratios and average betas[3] were similar to those of Northwestern Bell. The 50.1 equity component adopted by the Commission approximates the mean equity ratio calculated by Dr. Thompson for the five comparable groups. We therefore conclude the Commission's adoption of a 50.1 percent hypothetical equity ratio was reasonable.

8. Directory Revenues.

In December 1983, shortly before the hearings began on Northwestern Bell's 1983 petition for a rate increase, Northwestern Bell decided to transfer its directory publication operations to U.S. West Direct. In making this transition, Northwestern Bell transferred certain assets to Landmark Publishing, U.S. West Direct's parent com-

[3]A beta is a measure of the volatility of the rate of return of a stock, relative to the stock market as a whole. Relatively less movement of a stock in the market renders that stock less risky, and vice-versa.

pany, and entered into a series of contracts with U.S. West Direct. When the Commission learned of the transfer, it directed the ALJ to consider this transfer in making its recommendations regarding Northwestern Bell's rates.

In Northwestern Bell's initial direct testimony, filed September 1983 with its petition for a rate increase, Northwestern Bell did not adjust its test year financial date to reflect the directory transfer; rather, Northwestern Bell included income, expenses, and investments from directory operations, as in the past, in the calculation of its 1983 test year revenue requirements. Northwestern Bell urged that no modification to its test year financials was justified, since its approach would insulate ratepayers from any possible detrimental effects of the transfer.

Upon learning of the transfer, the Commission requested the parties to discuss in the evidentiary hearings and any future filings the question whether the sale of the directory operations to U.S. West Direct, and the consequent replacement of Northwestern Bell's directory income with fees paid by U.S. West Direct, would have an effect on Northwestern Bell's ratepayers.

The intervenors proposed that the Commission either void Northwestern Bell's transfer of its directory operations and require Northwestern Bell to resume publication, or make an upward adjustment in Northwestern Bell's operating income to account for the growth which would have occurred if Northwestern Bell had continued to publish its directories. The DPS proposed that the Commission take the average of the past three years' growth levels in Northwestern Bell's net directory income, and add that amount to Northwestern Bell's test year operating income.

The ALJ recommended that the Commission adopt the DPS's imputed growth levels, and impute $2,526,666 in directory revenues to Northwestern Bell.

In its 1984 order, the Commission adopted the intervenors' first proposal, voided the transfer, and directed the return of directory operations to Northwestern Bell. On appeal, this court reversed, concluding that the Commission lacked such authority. *See In re Northwestern Bell Telephone Co.*, 367 N.W.2d 655 (Minn. Ct. App. 1985).

In its 1987 order after reconsideration, the Commission adopted the intervenors' alternative proposal and the ALJ's recommendation

that $2,526,666 be imputed to Northwestern Bell to account for expected revenues from its directory publication.

On appeal, Northwestern Bell argues that the Commission should not have adopted this imputed income, by reason of the following language in this court's opinion in *Northwestern Bell*:

> [T]he Commission is ordered to reinstate the contract between Northwestern and West Direct. The Commission can make a review of the transfer and its future impact on Northwestern's rates on a more complete record **in the next rate case**. If appropriate, an adjustment can be made at that time.

Id. at 663 (emphasis added). Northwestern Bell argues that this language precludes the Commission from imputing directory income in the present case, which is not the equivalent of a "next rate case."

We note, however, the following language in *Northwestern Bell*:

> The Commission can investigate the reasonableness of the publishing fees paid by West Direct to Northwestern pursuant to its inherent power to include the expenses, revenues and investment related to directory advertising in telephone ratemaking proceedings. The Commission's authority is limited to either accepting or rejecting the ALJ's recommendation of imputing income to Northwestern.

Id. at 661.

The Commission was free to review the record and revise it in a reasonable manner. Since this court held that the Commission had no authority to void the directory transfer, the only option for the Commission when it vacated the 1984 order was either to accept or reject the ALJ's recommendtaion of imputing income to Northwestern Bell.

The Commission in its 1987 order accepted the findings of the ALJ that Northwestern Bell's revenues should be increased by $2,527,000 as a result of imputed income from the directory revenues, reasoning that "[t]he benefits appears to lay heavily on

the side of U.S. West's shareholders without a corresponding benefit falling to Minnesota ratepayers." The Commission also adopted the ALJ's reasoning that Northwestern Bell failed to provide the Commission with appropriate date regarding the potential revenue impact of the directory transfer and that substantial evidence supported imputation of income.

The record supports the Commission's imputation of $2,526,666 in income. That number was obtained by using figures provided by Northwestern Bell, even though Northwestern Bell challenged the accuracy of its figures. The ALJ noted that deficiencies in the record caused by a lack of information provided by Northwestern Bell should not require imputation of a lesser amount. Northwestern Bell had the burden of proving its rate increase was reasonable, *See* Minn. Stat. § 237.075, subd, 4. We believe the ALJ did the best he could, based upon the data which Northwestern Bell did provide. The Commission's acceptance of the ALJ's findings and recommendations was not arbitraty and capricious, and those findings and recommendations are supported by the record.

9. Tax Surplus.

In 1983, in a prior rate decision, the Commission adjusted Northwestern Bell's test year figures to amortize, over a three year period, a deferred tax reserve surplus that had resulted from a reduction in federal tax rates.

In its 1984 rate order, the Commission continued to amortize the excess deferred taxes over the three year period.

> The Commission concludes that the surplus tax reserve should continue to be amortized over a three year period as ordered in [the previous 1983 decision].

We must assume that by 1987, the entire tax surplus had been returned to the ratepayers in the form of reduced rates.

In its 1987 order, the Commission ordered Northwestern Bell to return prospectively to it ratepayers the difference between the $57,148,000 rate increase allowed in 1984 and the $45,000,000 rate increase authorized by the 1987 modified order. In that order, however, the Commission did not take into account the fact that Northwestern Bell, after 1985, would have been allowed to charge higher rates, because the three year amortization period of the excess tax reserve surplus would have expired. The Commission

erred by failing to take this fact into account.

10. Touch-Tone and Speed Call 8 Services.

Northwestern Bell provides two servies that were the subject of this 1984 rate design: Touch-Tone and Speed Call 8. The Touch-Tone service enables a telephone user to dial a number by pushing number buttons on the telephone, rather than using a rotary dial. The Speed Call 8 service enables a user to dial preprogrammed two-digit codes, rather than dialing a complete telephone number.

In its 1984 rate order, the Commission set Speed Call 8 and Touch-Tone rates for handicapped persons at $1, in order to facilitate use of the telephone system by those persons. In its 1987 modification of the 1984 order, the Commission ordered Northwestern Bell to provide the Touch-Tone and Speed Call 8 services to handicapped persons without charge.

By requiring handicapped customers to pay for basic local services, but giving them the Touch Tone and Speed Call 8 services free, the Commission attempted to equalize the value of service available to the handicapped customer with that available to non-handicapped customers. In other words, because certain disabilities make the use of a regular telephone difficult, many handicapped customers derive less value from standard telephone service than do other customers.

The Commission's decision regarding this issue involves rate design, which requires the Commission to exercise its legislative decision-making authority. Such authority involves policy decisions, and this court's review is limited to upholding the Commission's action unless it has resulted in unjust, unreasonable or discriminatory rates, or has produced an arbitrary result. *See Hibbing Taconite Co. v. Minnesota Public Utilities Commission*, 302 N.W.2d 5, 9 (Minn. 1980).

While we applaud the reasoning behind the Commission's exercise of its authority in this instance, nevertheless there is no evidence in the record supporting the Commission's decision. While Northwestern Bell has the burden of proving by clear and convincing evidence that the Commission's determination was erroneous, it was unable to meet this burden because, at the time the Commission's decision was rendered in 1984, Northwestern Bell was not aware that the Commission was considering the provison of free services to the handicapped; thus, no evidence was introduced on this issue.

Regulatory statutes obligate the Commission to set "just and reasonable" rates. *See* Minn. Stat. § 237.075, subd. 6. By requiring Northwestern Bell to give away services free of charge without considering the actual effect upon Northwestern Bell's rate of return, the Commission has violated its responsibility to ensure that Northwestern Bell may charge reasonable rates.

Respondents point to evidence that the markup for the Touch-Tone services is 1,567%, and argue that other ratepayers will make up the revenue lost by the provision of the free services to the handicapped customers. Respondents also not that those persons eligible for the free Touch-Tone and Speed Call 8 services must continue to pay charges for basic local service.

The record indicates only the Northwestern Bell's other non-handicapped, customers will be paying for all Touch-Tone and Speed Call 8 services. It does not, as respondents argue, demonstrate that other ratepayers will "make up the revenue foregone" by providing free services to handicapped customers. We therefore conclude that this portion of the Commission's order must be reversed.

We have considered Northwestern Bell's other arguments and find them to be without merit.

DECISION

Affirmed in part and reversed in part.

December 22, 1987 Susanne C. Sedgwick

APPENDIX 12

STATE OF MINNESOTA
IN SUPREME COURT
C7-87-1296 and C9-87-1297

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commission. (C7-87-1296)

In the Matter of the Petition of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota. (C9-87-1297)

ORDER

Based upon all the files, records and proceedings, herein,

IT IS HEREBY ORDERED that the petition of Northwestern Bell Telephone Company for further review be, and the same is, denied.

Dated: 3-18-88

BY THE COURT:

Chief Justice

APPENDIX 13

C7-87-1296
C9-87-1297

STATE OF MINNESOTA
IN SUPREME COURT

Northwestern Bell Telephone Company,

Petitioner,

v.

Minnesota Public Utilities Commission,

Respondent.

PETITION FOR RECONSIDERATION

Northwestern Bell Telephone Company ("NWB") hereby petitions the Minnesota Supreme Court pursuant to Rule 140.01 of the Minnesota Rules of Civil Appellate Procedure for reconsideration of its Order dated March 18, 1988, denying NWB's petition for further review. The Supreme Court's decision let stand a decision of the Court of Appeals dated December 28, 1987, which affirmed two orders of the Minnesota Public Utitilies Commission ("the Commission"). These orders re-opened a three-year-old final telephone rate case and prospectively lowered NWB's revenue by over $12 million annually. In the opinion of NWB, the Supreme Court has overlooked, failed to consider, misapplied or misconceived the following material questions involving constitutional and statutory issues:

1. Whether the federal district court's explicit order in *United States v. American Telephone & Telegraph Co.*, 552 F. Supp. 131

(D.D.C. 1982), that NWB's capital structure consist of 45 percent debt and 55 percent equity pre-empted the Commission's authority to impose on NWB a radically different hypothetical capital structure, thus depriving the Commission of jurisdiction to take such action.

2. Whether the Commission's refusal to permit NWB argument in the reconsideration of the rate case (which thus precluded NWB from orally arguing to the newly constituted Commission that its capital structure was mandated by federal court order) violated the Supreme Court's October 1987 opinion in *In re The Petition of Northern States Power Co.*, 414 N.W.2d 383, 388 (Minn. 1987) ("*NSP*"), Minnesota Statutes Section 14.57, and deprived NWB of its right to due process guaranteed by the Minnesota and United States Constitutions.

3. Whether, by depriving NWB of a fair return on its investment, the Court of Appeals' and the Commission's decisions violated the just compensation clause of the Fifth Amendment to the United States Constitution, the Minnesota Constitution and section 237.075, subd. 6 of the Minnesota Statutes.

4. Whether the failure by the Commission to use contested case hearing procedures in connection with the investigation by the Department of Public Service into contacts between NWB and the Public Utilities Commission constituted a denial of NWB's right to due process guaranteed by the Constitutions of Minnesota and the United States, and a violation of Minnesota Statutes.

5. Whether the failure of the Commission to explain its denial of NWB's petition for reconsideration, which raised many new issues and arguments, violated Minnesota Statutes, section 14.62(1) and established Minnesota case law.

ARGUMENT

In determining in 1987 that its order in the 1984 rate case should be re-decided, and in issuing its new rate order, the Commission violated significant rights of NWB guaranteed by the federal and state Constitutions.

1. The Pre-Emption Doctrine of the United States Consitution Deprived the Commission of Jurisdiction to Impose a Hypothetical Capital Structure in Its 1987 Decision.

The largest single component of the Commission's 1987 reduction of NWB's rate increase resulted from its rejection of NWB's actual capital structure (which had been approved by the Commission in 1984 and agreed to by the Attorney General, Residential Utilities Division) and the imposition in its stead of a hypothetical capital structure with a higher debt ratio.[1] The Commission's 1987 imputation of that hypothetical capital structure to NWB, which was affirmed by the Minnesota Court of Appeals, was pre-empted by federal law, and the Commission thus lacked jurisdiction to take that action.

On August 24, 1982, the United States District Court for the District of Columbia entered an order known as the Modification of Final Judgment in the federal government's antitrust action against American Telephone and Telegraph Company ("AT&T") and certain affiliated companies. *United States v. American Telephone & Telegraph Co.*, 552 F. Supp. 131 (D.C.D.C. 1982). In its action, the United States had alleged Sherman Act violations and sought the divestiture from AT&T of the Bell Operating Companies. *Id.* at 139. Northwestern Bell was one of those Bell Operating Companies. After years of litigation, and at the conclusion of the presentation of the Justice Department's and AT&T's cases in chief at trial, the parties agreed to a consent decree that provided for the divestiture of the Bell Operating Companies and set forth in detail structural changes containing restrictions designed to prevent the Operating Companies from discriminating against AT&T's competitors, and to avoid a recurrence of the types of discriminating cross-subsidizations that were alleged to be the basis of the lawsuit. *Id.* at 142–143.

The Court carefully scrutinized the proposed consent decree pursuant to the requirements of the Tunney Act, 15 U.S.C. § 16(e), which provides that a proposal for a consent judgment submitted by the United States in an action brought under the antitrust laws may not be entered by the court without prior compliance with certain procedures, including a determination by the court that the entry of the judgment is in the public interest. In making that determination, the court is to consider, among other things, the

impact of the entry of such judgment upon the public generally, as well as the competitive impact of the judgment and its impact upon individuals alleging specific injury from the alleged violations. The procedures required by the Act include a 60-day comment period, publication of a competitive impact statement by the Department of Justice, and a 60-day period for the receipt of public comments. In analyzing the Tunney Act's requirement, the court stated: "It is clear that Congress wanted the courts to act as an independent check upon the terms of decrees negotiated by the Department of Justice, and this Court will review the instant settlement in that spirit." *Id.* at 149 (footnote omitted).

In satisfying these obligations imposed by the Tunney Act, the federal district court evaluated the debt-equity ratios to be assumed by the Operating Companies. *Id.* at 207–208, 226. AT&T had stated its intention, to which the government agreed, to divest the Operating Companies, such as NWB, with a debt ratio of approximately 45 percent. The Court required the proposed consent decree to be modified to incorporate a 45 percent debt ratio, saying:

> The Court considers that its Tunney Act responsibilities require it demand more of the parties on subjects which have significant public interest aspects than statements of intention embodied in briefs or written comments, or made during oral argument. Accordingly, **the Court will require** that the proposed decree be modified to incorporate the forty-five percent debt ratio and the government's and AT&T's representations with regard to the quality of the Operating Company debt, to the end that on the basis of such a modification the Court will be in a position, if necessary, to insist that the statements of intention of the parties are actually implemented.

Id. at 207–08 (emphasis supplied).

It its Order modifying the final judgment, the court stated:

> At the time of the transfer of ownership provided for in section I(A)(4), **the separated BOCs shall have debt ratios of approximately forty-five percent** (except for Pacific Telephone & Telegraph Company which shall have a debt ratio of approximately fifty percent), and the qual-

> ity of the debt shall be representative of the average terms and conditions of the consolidated debt held by AT&T, its affiliates and the BOCs at that time. Upon application by a party or a BOC, the Court may grant an exception to this requirement.

Id. at 226 (emphasis supplied).

The Court's decision was not contingent upon the state regulators' approval of these debt-equity ratios. One of the Bell operating companies, Pacific Telephone, had at the time of Modification of Final Judgment a substantially higher debt-equity ratio of approximately 57 percent. The Court did not require AT&T to reduce Pacific Telephone's debt to 45 percent, but accepted a reduction of Pacific's debt to around 50 percent. The Court did not condition its order on approval by the State of California of the ratio. Thus, in assessing its obligations created by Congress in the Tunney Act, the federal district court imposed an obligation on Pacific Telephone & Telegraph to use a 50 percent debt-equity ratio, notwithstanding the use by California regulators of a debt-equity ratio as high as 57 percent. *Id.* at 208 n.320.

In 1983, several parties to the antitrust case attempted to convince the Court that the capital structure imposed by the Modification of Final Judgment was inequitable, in part because the various Bell Companies operated under different tariffs. The Court disagreed, saying:

> Because the decree provides that the Operating Companies and AT&T will each receive a portion of the consolidated debt and equity of the Bell System[59], it is reasonable for each of the post-divestiture entities also to receive a corresponding portion of the system's pre-divestiture business risks which encumber equity.

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[59] The decree provides that AT&T is to divest the Operating Companies with 45 percent debt ratios (55 percent equity) . . . .

United States v. Western Electric Co., Inc., 569 F. Supp. 1057, 1072 (D.D.C. 1983).

The federal court order has pre-empted the state from imposing

a hypothetical capital structure that would violate that federal court order. Federal law pre-empts state law when state law actually conflicts with federal law, which arises when compliance with both federal and state law is impossible. *Michigan Canners & Freezers Ass'n., Inc. v. Agricultural Marketing and Bargaining Board,* 467 U.S. 461, 469 (1984). In that case, the Supreme Court held that the state law at issue was pre-empted by the federal legislation, because the state law authorized agricultural producers associations to engage in conduct prohibited by federal law. *Id.* at 478. In this case, the Commission has ordered that it was unreasonable for NWB to use the capital structure ordered by the federal district court, thus requiring NWB to engage in conduct prohibited by federal law or penalize it for failing to engage in such conduct.

In 1984, Northwestern Bell argued that the use of any hypothetical capital structure containing less than 55 percent equity would be "patently unfair and unlawful, regardless of the evidence." Initial Brief, April 30, 1984, at pp. 159-160. Northwestern Bell specifically argued that the federal court's order mandating divestiture of the Bell Operating Companies had required them to have debt ratios of approximately 45 percent and that the imposition of a capital structure using less than 55 percent equity would conflict with the order of the United States District Court. In 1984, the Commission's decision was in compliance with the debt ratio set by the federal court's divestiture order. In its 1987 order after redeliberation, however, the Commission imposed a debt-equity ratio of 50.1%, thus imputing to NWB a capital structure that would not have been in compliance with the Modification of Final Judgment. Both in 1984 and in redeliberation in 1987, the Commission's rate decisions were based on 1983 test year data, adjusted to reflect the effects resulting from the divestiture order. The 1987 imputation of the hypothetical debt ratio is barred by the pre-emption doctrine and thus violates the United States Constitution.

Other state utility regulatory commissions have agreed that for the post-divestiture period, the capital structure requirements of the federal court's Modification of Final Judgment control for ratemaking purposes. In *Illinois Bell Telephone Co.,* 57 P.U.R. 4th 225, 263 (Ill. Comm. Comm'n 1983), the Illinois Commerce Commission refused to impute a hypothetical capital structure as a result of the Modified Final Judgment. In *Chesapeake Potomac Tel. Co.,* 74

Md. P.S.C. 595 (1983), the Maryland Public Service Commission reached the same result, saying:

> We are persuaded that the MFJ (the federal court order) **leaves no alternative** other than for C&P Telephone Company of Maryland to be divested with a capital structure which is not in excess of 45 percent debt. Since this is a legal requirement established by the U.S. District Court and is binding upon AT&T as well as the divested local operating companies, we conclude that we should adopt a capital structure that conforms with that requirement. . . . As a consequence, the Modification of Final Judgment will establish, for practical purposes, the maximum amount of debt capital which will comprise the Company's capital structure throughout much of the rate-effective period.

(emphasis supplied).

Respondents argued in opposition to the Petition for Review that the Supreme Court, in its recent decision in *In re Northern States Power,* 414 N.W.2d 383 (1987) had already approved the Commission's authority to impose a hypothetical capital structure. That argument overlooks the critical fact that NWB's capital structure was mandated by federal court order. NSP was subject to no such federal order. The *NSP* decision, therefore, does not control with respect to NWB's capital structure.

2. The Refusal to Permit Oral Argument in the 1987 Reconsideration of the Rate Case Constitutes a Denial of NWB's Right to Due Process.

After the Commission decided in 1987 to re-open the 1984 rate case, it re-decided that case on the basis of the record of the prior proceeding. The Commission did not permit NWB oral argument in its re-decision of this rate case, despite the express requirement of Minnesota Statues section 14.61 that it do so. As a result, the Commission's action, affirmed by the Court of Appeals, violates fundamental principles of due process and fairness, as well as Minnesota Statutes section 14.61.

In essence, the Court of Appeals ruled that NWB was not

entitled to oral argument because its ex parte contacts with the Commission denied it the right to be treated fairly. Constitutional rights, however, cannot be violated by merely espousing equitable maxims. NWB had a constitutional right, expressly recognized by statute, to present argument to those Commission members deciding a highly complicated rate case, in which $57 million of rate relief had previously been deemed necessary to afford a reasonable return to NWB's shareholders. The basis on which oral argument was denied to NWB was arbitrary, capricious, and punitive. As a result, that denial of oral argument constituted a violation of NWB's constitutionally protected right to due process.

3. The Commission's Redeliberated Order Violates the United States and Minnesota Constitutions by Depriving NWB of a Reasonable Return on its Investment.

The Fifth Amendment to the United States Constitution provides that private property shall not be taken for public use without just compensation, and it is enforceable against the States through the Due Process Clause of the Fourteenth Amendment. *Webb's Fabulous Pharmacies, Inc. v. Beckwith,* 449 U.S. 155, 159 (1980). The Minnesota Constitution similarly requires just compensation when private property is taken for public use. Minn. Const., Art. I, § 13. In the context of public utility rate regulation, the requirement of just compensation is met only if the rates permit the utility to earn a reasonable rate of return on its investment. *West v. Chesapeake & Potomac Tel. Co.,* 295 U.S. 662, 671 (1935); *Bluefield Waterworks & Improvement Co. v. Public Service Comm'n,* 262 U.S. 679 (1923); *Hibbing Taconite Co. v. Minnesota Public Service Comm'n,* 302 N.W.2d 5, 10 (Minn. 1981). The Commission also has a statutory duty to set rates at a level which ensures a fair and reasonable return on NWB's investment. Minn. Stat. § 237.075, subd. 6. The Commission's Order violates this constitutional protection.

By imputing a hypothetical capital structure to NWB, the Commission chose to ignore the reality that NWB's capital structure is mandated by the federal court's divestiture order in *United States v. American Telephone & Telegraph Co., supra.* Its imputation of a hypothetical capital structure requires the assumption that NWB

would use the capital structure that it was actually prohibited from using by federal court order. The company simply cannot earn a fair and reasonable return on its investment if the hypothetical capital structure imposed by the Commission is used to set that rate of return. Similarly, by imputing directory service revenues to NWB that it could have hypothetically earned, in the face of the Court of Appeals' earlier reversal of the Commission's order requiring NWB to engage in those directory operations, the 1987 decision has a confiscatory result. The Commission has thus prevented NWB from earning a fair return on its investment in violation of the Minnesota and United States Constitutions and state statutes.

4. The Failure to Permit NWB the Opportunity to Cross-Examine Witnesses or to Otherwise Use Contested Case Hearing Procedures Deprive NWB of its Constitutionally Guaranteed Rights to Due Process and Violates Minnesota Statutes.

The Commission's re-opening of the 1984 rate case was based on an investigation by the Department of Public Service of contacts between NWB and the Commisison. Because the Commission was engaged in a rate-making proceeding involving disputed facts, it was required by Minnesota Statutes, Section 237.075, and the Minnesota Administrative Procedure Act to use contested case hearing procedures in re-opening the case. *State v. Tri-State Tel. & Tel. Co.*, 284 N.W. 294 (1939); *see, Continental Tel. Co. of Minn., Inc.*, 389 N.W.2d 901 (Minn. 1986). The Commission, however, did not use contested case hearing procedures as required by law.

The Department of Public Service produced a report of its investigation of contacts between NWB and Commission members. Instead of conducting a contested case proceeding into whether the rate case should be re-opened, the Commission merely took administrative notice of that report, together with depositions taken by the Department of Public Service and other exhibits. Many of these exhibits consisted of affidavits and memoranda of interviews or telephone conversations with individuals conducted by the Department of Public Service. NWB had neither prior notice of these interviews or the preparation of these Affidavits, nor the opportunity to cross-examine the witnesses involved in them. Many of the exhibits to the report were not disclosed to NWB until after the DPS report was filed. The Commission rebuffed NWB's objection

to such documents serving as the basis for the Commission's action. As a result, NWB was denied its fundamental due process rights guaranteed by the federal and state constitutions and Minnesota statutes.

5. The Commission's Failure to Make Findings on Substantive Issues Raised by NWB in 1987 Violated Minnesota Statutes and Evidences the Arbitrary and Capricious Nature of its Decision.

The Commission is required to deal fairly with all material issues raised by the parties and to make findings sufficient to allow meaningful appellate review. *Hibbing Taconite Co. v. Minnesota Public Service Commission,* 302 N.W.2d 5, 12 (Minn. 1980). The failure to do so indicates that the Commission has not engaged in reasoned decision-making, and has exercised its will rather than its judgment. *Yellowbird, Inc. v. MSP Express, Inc.,* 377 N.W.2d 490, 494 (Minn. App. 1985). Many substantive issues were raised by NWB in its Petition for Reconsideration of the Commission's 1987 Order after its redeliberation of the earlier rate case, because the Commission had not allowed written submissions from NWB earlier. The new issues included the reversal by the Court of Appeals of a decision on which the Commission had relied, and the argument that the imputation of directory revenues to NWB was contrary to both Minnesota Supreme Court decisions and the decision of the Court of Appeals on this very issue in this rate case in 1986.

In response, the Commission merely claimed that nothing new had been raised in the Petition, stated that all matters had been thoroughly considered, and failed to even mention the new issues. The Court has the duty to intervene when a combination of danger signals suggests that the agency has not taken a hard look at the salient problems and has not genuinely engaged in reasoned decision-making. *Yellowbird, supra,* 377 N.W.2d at 493; *Reserve Mining Co. v. Herbst,* 256 N.W.2d 808, 824–25 (Minn. 1977). The absence of contested case hearing procedures, the reliance on inadmissible documents, the refusal to follow statutory procedures, the denial of a requested oral argument, the refusal to articulate reasons for decision of key issues, and the overall emphasis on a punitive result compel the conclusion that the Supreme Court must exercise its duty to review this case.

CONCLUSION

NWB respectfully petitions the Supreme Court to reconsider the denial of NWB's Petition for Supreme Court review of the decision of the Court of Appeals. NWB believes that in denying the Petition for Review, the Supreme Court has overlooked, misconstrued or misapplied federal and state constitutional principles as well as state statutes. Specifically, NWB claims that the Commission's action:

1. Has denied NWB due process required by the Federal and State Constitutions and by Minnesota statute;
2. Was pre-empted by federal law;
3. Constitutes a taking of NWB's property without just compensation in violation of the federal and state Constitutions and Minnesota statutes;
4. Violates the Administrative Procedures Act, Minn. Stat. §§ 14.61 and 14.52, subd. 1;
5. Violates the protections guaranteed to a utility by the rate-making statute, Minn. Stat. § 237.075; and
6. Violates the statutory requirement that approved telephone rates be observed until changed as provided by statutory procedures, Minn. Stat. § 237.075, subd. 5.

For the foregoing reasons, as well as those urged in NWB's Petition for Further Review dated January 27, 1988, NWB requests that the Court reconsider its Order dated March 18, 1988, denying further review.

March 28, 1988

APPENDIX 14

STATE OF MINNESOTA
IN SUPREME COURT
C7-87-1296 and C9-87-1297

In the Matter of the Minnesota Public Utilities Commission's Initiation of Summary Investigation of the Nature and Extent of Contacts Between Public Utilities and Telephone Companies and Former Minnesota Public Utilities Commission. (C7-87-1296)

In the Matter of the Petition of Northwestern Bell Telephone Company, Minneapolis, Minnesota for Authority to Change its Schedule of Telephone Rates for Customers Within the State of Minnesota. (C9-87-1297)

ORDER

Based upon all the files, records and proceedings, herein,

IT IS HEREBY ORDERED that Northwestern Bell Telephone Company's petition for reconsideration of the denial of its petition further review be, and the same is, denied.

Dated: April 4, 1988

BY THE COURT:

Chief Justice